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Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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JOINT COMMITTEE ON TAXATION

110TH CONGRESS, 2ND SESSION

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CONTENTS

Page

INTRODUCTION 1

I. MAKE PERMANENT TAX CUTS ENACTED IN 2001 AND 2003 2

A. Permanently Extend Certain Provisions Expiring Under EGTRRA and JGTRRA 2

II. TAX INCENTIVES 8

A. Provisions Related to Savings 8
1. Expansion of tax free savings opportunities 8
2. Consolidation of employer-based savings accounts 20
B. Increase in Limitations on Expensing of Certain Depreciable Business Assets 34
C. Provisions Relating to Health Care 38
1. Provide a standard deduction for health insurance 38
2. Expand and make health savings accounts more flexible 63
3. Expand human clinical trial expenses qualifying for the orphan drug tax credit 75
D. Provisions Relating to Charitable Giving 78
1. Permanently extend tax-free withdrawals from individual retirement arrangements for charitable contributions 78
2. Permanently extend the modified enhanced charitable deduction for contributions of food inventory 84
3. Extend deduction for corporate donations of computer technology 86
4. Permanently extend increased limits on contributions of partial interests in real property for conservation purposes 89
5. Permanently extend the basis adjustment to stock of S corporations contributing appreciated property 93
6. Reform excise tax based on investment income of private foundations 94
E. Provisions Relating to Education 101
1. Permanently extend the above-the-line deduction for qualified out-of-pocket classroom expenses 101
2. Allow the Saver's credit for contributions to qualified tuition programs (section 529 plans) 103
3. Allow use of qualified mortgage bonds to refinance home mortgages for subprime borrowers 110
F. Environment and Conservation Related Provisions 114
1. Permanently Extend Expensing of Brownfields Remediation Costs 114
2. Eliminate the volume cap for private activity bonds for water infrastructure 116
G. Restructure Assistance to New York 119

III. SIMPLIFY THE TAX LAWS FOR FAMILIES 123

A. Clarify Uniform Definition of Child 123

B. Simplify EIC Eligibility Requirements Regarding Filing Status, Presence of Children, and Work and Immigrant Status 130
C. Reduce Computational Complexity of Refundable Child Tax Credit 136

IV. IMPROVE TAX COMPLIANCE 140

A. Expand Information Reporting 140
1. Require information reporting on payments to corporations 140
2. Require basis reporting on security sales 141
3. Require information reporting on merchant payment card reimbursements 146
4. Require a certified taxpayer identification number from contractors 148
5. Increased information reporting for certain government payments for property and services 151
6. Increase information return penalties 153
7. Improve the foreign trust reporting penalty 155
B. Improve Compliance by Businesses 158
1. Require e-filing by certain large organizations 158
2. Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes 160
C. Strengthen Tax Administration 165
1. Allow Internal Revenue Service ("IRS") to access information in the National Directory of New Hires ("NDNH") 165
2. Permit disclosure of prison tax scams 166
3. Make repeated willful failure to file a tax return a felony 169
4. Facilitate tax compliance with local jurisdictions 170
5. Extension of statute of limitations where State tax adjustment affects Federal tax liability 172
6. Improve investigative disclosure statute 174
7. Impose penalty on failure to comply with electronic filing of returns 175

V. IMPROVE TAX ADMINISTRATION AND OTHER MISCELLANEOUS PROPOSALS 177

A. Modify Section 1203 of the IRS Restructuring and Reform Act of 1998 177
B. Termination of Installment Agreements 181
C. Office of Chief Counsel Review of Offers in Compromise 183
D. Extension of IRS Authority to Fund Undercover Operations 184
E. Increase Transparency of the Cost of Employer-Provided Health Coverage 186
F. Conform Penalty Standards for Preparers and Taxpayers 189
G. Eliminate the Special Exclusion from Unrelated Business Taxable Income ("UBIT") for Gain or Loss on Sale or Exchange of Certain Brownfield Properties 192
H. Impose Stricter Limits on Related-Party Interest Deductions by Expatriated Entities 202
I. Repeal Excise Tax on Communications Services 215
J. Modify Financing of the Airport and Airway Trust Fund 218
K. Modify Financing of the Inland Waterways Trust Fund 229

VI. IMPROVE UNEMPLOYMENT INSURANCE 231

A. Strengthen the Financial Integrity of Unemployment Insurance 231
B. Extension of Federal Unemployment Surtax 234

VII. ENERGY PROVISIONS 235

A. Repeal Temporary 15-Year Recovery Period for Natural Gas Distribution Lines... 235
B. Modify Amortization for Certain Geological and Geophysical Expenditures 239

VIII. EXTEND EXPIRING PROVISIONS 241

A. Extend Alternative Minimum Tax Relief for Individuals..... 241
B. Permanently Extend the Research and Experimentation ("R&E") Tax Credit 245
C. Extend District of Columbia Homebuyer Tax Credit 264
D. Deferral of Gains From the Sale of Electric Transmission Property 267
E. Extend the New Markets Tax Credit 270
F. Subpart F Exception for Active Financing Income 274
G. Look-Through Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Income Rules..... 283
H. Qualified Retirement Plan Distributions to Individuals Called to Active Duty 286
I. Extend Provisions Permitting Disclosure of Tax Return Information Relating to Terrorist Activity 288
J. Disclosure of Tax Return Information for Administration of Veterans Programs ... 294
K. Extend Excise Tax on Coal at Current Rates..... 296
L. Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit..... 298

IX. OTHER PROVISIONS..... 300

A. Extension of the Rate of Rum Excise Tax Cover Over to Puerto Rico and Virgin Islands..... 300
B. Disclosure of Tax Return Information for Administration of Student Financial Aid..... 302
C. Transition from the Non-Foreign Cost-of-Living Adjustment to Locality Pay for Employees in Non-Foreign Areas 308

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are contained in the President's fiscal year 2009 budget proposal, as submitted to the Congress on February 4, 2008.[2] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget proposal.[3] For each provision, there is a description of present law and the proposal (including effective date), a reference to relevant prior budget proposals or recent legislative action, and an analysis of policy issues related to the proposal.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal* (JCS-1-08), March 2008.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2009: Analytical Perspectives* (H. Doc. 110-84, Vol. III), at 253-267.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals*, February 2008.

I. MAKE PERMANENT TAX CUTS ENACTED IN 2001 AND 2003

A. Permanently Extend Certain Provisions Expiring Under EGTRRA and JGTRRA

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the Federal tax laws, including reducing individual tax rates, repealing the estate tax, increasing and expanding various child-related credits, providing tax relief to married couples, providing additional education-related tax incentives, increasing and expanding various pension and retirement-saving incentives, and providing individuals relief relating to the alternative minimum tax.[4] However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974, EGTRRA included a "sunset" provision, pursuant to which the provisions of the Act expire at the end of 2010. For example, EGTRRA's provisions do not apply to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010.

EGTRRA provides that, as of the effective date of the sunset, the Code will be applied as though EGTRRA had never been enacted. For example, the estate tax, which EGTRRA repeals for decedents dying in 2010, will return as to decedents dying after 2010, in pre-EGTRRA form, without the various interim changes made by the Act (e.g., the rate reductions and exemption equivalent amount increases applicable to decedents dying before 2010). Similarly, the top individual marginal income tax rate, which EGTRRA reduced to 35 percent will return to its pre-EGTRRA level of 39.6 percent in 2011 under present law. Likewise, beginning in 2011, all other provisions of the Code will be applied as though the relevant provisions of EGTRRA had never been enacted.

The Jobs and Growth Tax Relief Reconciliation Act of 2003

In general

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") changed the expensing of certain depreciable business assets, individual capital gains tax rates and the tax rates on dividends received by individuals. The modifications to the expensing provision and the capital gains and dividend rate provisions sunset for taxable years beginning after December 31, 2010.

[4] The Pension Protection Act of 2006, Pub. L. No. 109-280, repealed the sunset contained in EGTRRA with respect to the pension and IRA provisions contained in subtitles A through F of title VI of EGTRRA and with respect to the qualified tuition program provisions in section 402 of EGTRRA.

Expensing provisions

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[5] For taxable years beginning in 2008, the maximum amount that a taxpayer may expense is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000.[6] For taxable years beginning in 2009 and 2010, the maximum amount that a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[7]

For taxable years beginning in 2011 and thereafter, other rules apply.[8]

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[5] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[6] The temporary $250,000 and $800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185.

[7] Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

[8] Under the rules in effect for taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a

Individual capital gains rates

Under JGTRRA, for taxable years beginning before January 1, 2011, generally the maximum rate of tax on net capital gain of a non-corporate taxpayer is 15 percent. In addition, any net capital gain which otherwise would have been taxed at a 10- or 15-percent rate generally is taxed at a zero-percent rate.

For taxable years beginning after December 31, 2010, generally the rates on net capital gain are 20 percent and 10 percent, respectively. Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10-percent rate is taxed at an eight percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate.

Taxation of dividends received by individuals

Under rules enacted in JGTRRA, dividends received by a non-corporate shareholder from domestic corporations and qualified foreign corporations generally are taxed at the same rates that apply to net capital gain. Thus, dividends received by an individual, estate, or trust are taxed at rates of zero and 15 percent. This treatment applies to taxable years beginning before January 1, 2011.

For taxable years beginning after December 31, 2010, dividends received by a non-corporate shareholder are taxed at the same rates as ordinary income.

Description of Proposal

The proposal repeals the sunset provisions of EGTRRA and JGTRRA.

Specifically, the proposal permanently extends all provisions of EGTRRA that expire at the end of 2010. Thus, the estate tax remains repealed after 2010, and the individual rate reductions and other provisions of the Act that are in effect in 2010 will remain in place after 2010.[9]

Also, the proposal permanently extends the provisions of JGTRRA relating to expensing,[10] capital gains, and dividends.

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trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner (sec. 179(c)(2)).

[9] However, certain provisions expire separately under the Act before the end of 2010. For example, the increased AMT exemption amounts expire after 2007, and thus is unaffected by the proposal.

[10] The President's fiscal 2009 budget proposal includes a separate proposal to increase the expensing limitation amounts under section 179 to $200,000 and $800,000, respectively, and make them permanent. That proposal is described in section II.B. of this document.

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

Analysis

In general

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

The decision to permanently extend the provisions of EGTRRA and JGTRRA would have a substantial impact on Federal revenues. Alternatively, leaving present law in place will result in a substantial increase in marginal tax rates for many taxpayers and an increase in taxes paid by individuals and businesses after 2010[11]. The increase in marginal tax rates may alter taxpayer decisions relating to labor force participation and saving and investment, and may also induce short term acceleration of income to avoid the increase in rates.

In essence, the principal decision with respect to addressing the EGTRRA and JGTRRA sunsets is a decision about the level, composition, and distribution of individual taxes and, to a lesser extent, business taxes. Such a decision should not be viewed as the binary choice of either eliminating the sunsets, or allowing the sunsets to take effect. Rather, policy makers need to determine, from today's vantage point rather than one imposed in 2001, the appropriate level, composition, and distribution of taxes and set policies accordingly. If it is determined that the revenues that would be received as a result of the present law sunset are not needed, there are ways to consider structuring the resulting tax system in addition to the option of simply eliminating the sunset. Similarly, if the revenues that would be received as a result of the present law sunset are in fact needed, there are ways to raise such revenue other than by allowing the sunset to take effect.

Complexity issues

The present-law sunset provisions of EGTRRA and JGTRRA arguably contribute to complexity by requiring taxpayers to contend with (at least) two different possible states of the law in planning their affairs. For example, under the sunset provision of EGTRRA, an individual planning his or her estate will face very different tax regimes depending on whether the

[11] This increase in revenues is part of present law and is thus already in baseline receipts forecasts. Thus the increase in tax revenues from 2010 to 2011 resulting from the sunset provisions does not constitute a tax increase relative to present law.

individual dies in 2010 (estate tax repealed) or 2011 (estate tax not repealed). This "cliff effect" requires taxpayers to plan an estate in such a way as to be prepared for both contingencies, thereby creating a great deal of complexity. On the other hand, some may argue that this kind of uncertainty is always present to some degree – with or without a sunset provision, taxpayers always face some risk that the Congress will change a provision of law relevant to the planning of their affairs. Others may acknowledge this fact, but nevertheless argue that the sunset provision creates an unusual degree of uncertainty and complexity as to the areas covered by the Act, because they consider it unlikely that the sunset will actually go into effect. In this view, the sunset provision of EGTRRA leaves taxpayers with less guidance as to the future state of the law than is usually available, making it difficult to arrange their affairs. In addition to the complexity created by the need to plan for the sunset, uncertainty about the timing and details of how the sunset might be eliminated arguably creates further complexity.

Even if it is assumed that the sunset provisions will take effect, it is not clear how the sunsets would apply to certain provisions. It would be relatively simple to apply the EGTRRA sunset to some provisions, such as the individual rate reductions. With respect to other provisions, however, further guidance would be needed as to the effect of the sunset. For example, if the Code will be applied after 2010 as if the Act had never been enacted, then one possible interpretation of the Coverdell education savings account provisions is that higher contributions made while EGTRRA was in effect will no longer be valid, possibly resulting in the loss of tax-favored status for such accounts. While this result was likely not intended, without further guidance taxpayers may be unsure as to the effect of the sunset.

More broadly, in weighing the overall complexity effects of the present-law sunsets and the proposed sunset repeal, some would point out that the sunset provisions are not the only feature of EGTRRA and JGTRRA that generates "cliff effects" and similar sources of uncertainty and complexity for taxpayers. For example, under EGTRRA's estate tax provisions, a decedent dying in 2008 has an exemption equivalent amount of $2 million, one dying in 2009 has an exemption equivalent amount of $3.5 million, and one dying in 2010 effectively has an infinite exemption but not a complete "step-up" in the basis of assets. Thus, the estates of individuals at certain wealth levels will incur significant estate tax if they die in 2008, but none at all if they die in 2009; the estates of individuals at other wealth levels will incur significant estate tax if they die in 2009, but none at all if they die in 2010. These discontinuities are not caused by the sunset provisions, but they generate a similar sort of uncertainty and complexity for many taxpayers. Similar phase-ins and phase-outs are found in other provisions of EGTRRA and generate complexity and uncertainty, irrespective of whether EGTRRA as a whole sunsets or not. In light of these issues, some may argue that a more detailed reconsideration of EGTRRA or certain of its provisions would better serve the goal of tax simplification.

Beyond phase-ins and phase-outs, some may argue that EGTRRA included other provisions that increased the complexity of the Code, and that allowing those provisions to expire at the end of 2010 (or effectively requiring that they be reconsidered before then) may reduce complexity, albeit potentially years in the future. Others would argue that some of EGTRRA's provisions reduced complexity, such as the repeal of the overall limitation on itemized deductions and changes relating to the earned income tax credit, and that permanently extending these provisions would contribute to simplification of the tax laws.

Prior Action

A similar proposal was included in the President's fiscal year 2003, 2004, 2005, 2006, 2007, and 2008 budget proposals.

II. TAX INCENTIVES

A. Provisions Related to Savings

1. Expansion of tax free savings opportunities

Present Law

In general

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

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

Individual retirement arrangements

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[12] to which both deductible and nondeductible contributions may be made,[13] and Roth IRAs.[14] The Federal income tax rules regarding each type of IRA (and IRA contributions) differ.

The maximum annual deductible and nondeductible contributions that can be made to a traditional IRA and the maximum contribution that can be made to a Roth IRA by or on behalf of an individual varies depending on the particular circumstances, including the individual's income. However, the contribution limits for IRAs are coordinated so that the maximum annual contribution that can be made to all of an individual's IRAs is the lesser of a certain dollar amount ($5,000 for 2008) or the individual's compensation.[15] In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this

[12] Sec. 408.

[13] Sec. 219.

[14] Sec. 408A.

[15] The dollar limit is indexed for years after 2008.

purpose, the dollar limit is increased by $1,000. IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the adjusted gross income phase-out ranges for 2008 are: (1) for single taxpayers, $53,000 to $63,000; (2) for married taxpayers filing joint returns, $85,000 to $105,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income for 2008 between $159,000 and $169,000.

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

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

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Early withdrawals from an IRA generally are subject to an additional 10-percent tax.[16] That is, includible amounts withdrawn prior to attainment of age 59-½ are subject to an additional 10-percent tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of adjusted gross income, is used to purchase health insurance of certain unemployed individuals, is used for higher education expenses, is used for first-time homebuyer expenses of up to $10,000, or is made to a member of a reserve unit called to active duty for 180 days or longer.

Distributions from traditional IRAs generally are required to begin by the April 1 of the year following the year in which the IRA owner attains age 70-½. Distributions are required to be made (in accordance with regulations) over the life or life expectancy of the IRA owner, or over the joint lives or joint life expectancy of the IRA owner and a designated beneficiary.[17] If an IRA owner dies after minimum required distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the

[16] Sec. 72(t).

[17] Treas. Reg. sec. 1.408-8 provides rules for required minimum distributions from IRAs.

date of death. If the IRA owner dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the IRA owner's death. The five-year rule does not apply if distributions begin within one year of the IRA owner's death and are payable (in accordance with regulations) over the life or life expectancy of a designated beneficiary. Special rules apply if the beneficiary of the IRA is the surviving spouse.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of a certain dollar amount ($5,000 for 2008) or the individual's compensation for the year. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a Roth IRA up to $1,000.

The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2008 are: (1) for single taxpayers, $101,000 to $116,000; (2) for married taxpayers filing joint returns, $159,000 to $169,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

Taxpayers (except for married taxpayers filing separate returns) with modified adjusted gross income of $100,000 or less generally may convert a traditional IRA into a Roth IRA..[18] The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

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

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions; (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was

[18] Under the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222), the $100,000 limit is repealed for taxable years beginning after December 31, 2009.

required to be included in income as a result of the conversion. The amount includible in income is also subject to the 10-percent early withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

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

Saver's credit

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[19] The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income of the taxpayer. For 2008, married taxpayers filing joint returns with adjusted gross income of $53,000 or less, head of household taxpayers with adjusted gross income of $39,750 or less, and single taxpayers with adjusted gross income of $26,500 or less are eligible for the credit. The adjusted gross income limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return. The credit is available with respect to contributions to various types of retirement savings arrangements, including contributions to a traditional or Roth IRA.

Coverdell education savings accounts

Present law provides tax-exempt status to Coverdell education savings accounts, meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary.[20] The aggregate annual contributions that can be made by all contributors to Coverdell education savings accounts for the same beneficiary is $2,000 per year. In the case of contributors who are individuals, the maximum contribution limit is reduced for individuals with adjusted gross income between $95,000 and $110,000 ($190,000 to $220,000 in the case of married taxpayers filing a joint return).[21] Contributions to a Coverdell education savings account are not deductible.

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[19] Sec. 25B.

[20] Sec. 530.

[21] Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the present-law contribution limit and the adjusted gross income levels do not apply for years beginning after December 31, 2010. Thus, for example, the limit on annual contributions to a Coverdell education savings account is $500 after 2010.

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

Qualified tuition programs

Present law provides tax-exempt status to a qualified tuition program, defined as a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions.[22] Under a qualified tuition program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary, or in the case of a State program, may make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified tuition program must be made in cash, and the program must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions to a qualified tuition program are not deductible. Contributions to a qualified tuition program generally are treated as a completed gift eligible for the gift tax annual exclusion.

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

Health savings accounts

A health savings account ("HSA") is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for qualified medical expenses.[23] Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and not subject to employment taxes if made by the individual's employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in

[22] Sec. 529.

[23] Sec. 223.

gross income and are subject to an additional 10 percent-tax unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. A high deductible health plan is a health plan that has a deductible that is at least $1,100 for self-only coverage or $2,200 for family coverage (for 2008) and that has an out-of-pocket expense limit that is no more than $5,600 in the case of self-only coverage and $11,200 in the case of family coverage (for 2008).

The maximum aggregate annual contribution that can be made to an HSA in 2008 is $2,900 in the case of self-only coverage and $5,800 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $900 in 2008, and $1,000 in 2009 and thereafter.

Archer medical savings accounts

Like HSAs, an Archer medical savings account ("Archer MSA") is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan.[24] Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for MSA purposes, a high deductible plan is a health plan with (a) an annual deductible of at least $1,950 and no more than $2,900 in the case of individual coverage and at least $3,850 and no more than $5,800 in the case of family coverage (for 2008), and (b) maximum out-of-pocket expenses of no more than $3,850 in the case of individual coverage and no more than $7,050 in the case of family coverage (for 2008); and (3) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

[24] Sec. 220.

Description of Proposal

In general

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

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

Retirement Savings Accounts

Under the proposal, an individual may make annual contributions to an RSA up to the lesser of $5,000[25] or the individual's compensation for the year. As under present-law rules for IRAs, in the case of a married couple, contributions of up to the dollar limit may be made for each spouse if the combined compensation of both spouses is at least equal to the total amount contributed for both spouses. Contributions to an RSA may be made regardless of the individual's age or adjusted gross income. Contributions to an RSA may be made only in cash. Contributions to an RSA are taken into account for purposes of the Saver's credit. Earnings on contributions accumulate on a tax-free basis.

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

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

Under the proposal, existing Roth IRAs are renamed RSAs and are subject to the rules for RSAs. In addition, existing traditional IRAs may be converted into RSAs. The amount converted is includible in income (except to the extent it represents a return of nondeductible contributions). No income limits apply to such conversions. For conversions of traditional IRAs made before January 1, 2010, the income inclusion may be spread ratably over four years. For conversions of traditional IRAs made on or after January 1, 2010, the income that results from the conversion is included for the year of the conversion.

[25] The contribution limit is indexed for inflation.

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

Amounts converted to an RSA from a traditional IRA or an Employer Retirement Savings Account ("ERSA")[26] are subject to a five-year holding period requirement. If an amount attributable to such a conversion (other than an amount attributable to a Roth-type account in an ERSA) is distributed from the RSA before the end of the five-year period starting with the year of the conversion or, if earlier, the date on which the individual attains age 58, becomes disabled, or dies, an additional 10-percent tax applies to the entire amount. The five-year period is determined separately for each conversion contribution. To determine the amount attributable to a conversion, a distribution is treated as made in the following order: (1) regular RSA contributions; (2) conversion contributions (on a first-in, first-out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion.

Lifetime Savings Accounts

Under the proposal, an individual may make nondeductible contributions to an LSA of up to $2,000 annually, regardless of the individual's age, compensation, or adjusted gross income.[27] Additionally, contributors other than the LSA owner may make contributions to an LSA. The contribution limit applies to all LSAs in an individual's name, rather than to the contributors making the contributions. Thus, contributors may make annual contributions of up to $2,000 each to the LSAs of other individuals but total contributions to the LSAs of any one individual may not exceed $2,000 per year. Contributions to LSAs may be made only in cash. Contributions to an LSA are not taken into account for purposes of the Saver's credit. Earnings on contributions accumulate on a tax-free basis.

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

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

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

[27] Total contributions to an LSA for a year may not exceed $2,000, regardless of whether any distributions are taken from the LSA during the year. The contribution limit is indexed for inflation.

Taxpayers may convert balances in Coverdell education savings accounts and qualified tuition programs to LSA balances on a tax-free basis before January 1, 2010, subject to certain limitations. An amount may be rolled over to an individual's LSA only if the individual was the beneficiary of the Coverdell education savings account or qualified tuition program as of December 31, 2007. The amount that can be rolled over to an LSA from a Coverdell education savings account is limited to the sum of: (1) the amount in the Coverdell education savings account as of December 31, 2007; and (2) any contributions to and earnings on the account for 2008. The amount that can be rolled over to an LSA from a qualified tuition program is limited to the sum of: (1) the lesser of $50,000 or the amount in the qualified tuition program as of December 31, 2007; and (2) any contributions to and earnings on the qualified tuition program for 2008. The total amount rolled over to an individual's LSA that is attributable to 2008 contributions for the individual to Coverdell education savings accounts and qualified tuition programs may not exceed $2,000 (plus any earnings on such contributions).

Under the proposal, qualified tuition programs continue to exist as separate arrangements, but may be offered in the form of an LSA. For example, State agencies that administer qualified tuition programs may offer LSAs with the same investment options that are available under the qualified tuition program. The annual limit on LSA contributions applies to such an LSA, but the additional reporting requirements applicable to qualified tuition programs under present law do not apply and distributions for purposes other than education are not subject to Federal tax.[28]

Effective date

The proposal is effective on January 1, 2009.

Analysis

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

By providing additional tax incentives for saving, the proposal intends to encourage additional saving generally. By providing a tax-favored savings account with no restrictions on withdrawals, the proposal intends to encourage additional saving in particular by those who are reluctant to take advantage of existing tax-preferred savings accounts because of withdrawal restrictions. Some argue that the national saving rate is too low, and that this is due in part to the bias of the present-law income tax structure against saving and in favor of current consumption. By removing the tax on the return to savings, the present-law income tax structure can be modified to function more like a consumption tax. Proponents of this approach argue that saving

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

will increase if the return to savings is not reduced by taxes. Others have argued that saving has not necessarily increased as a result of existing tax incentives for savings. Some have argued that much existing savings have merely been shifted into tax-favored accounts, and thus do not represent new saving.[29] Also, it may be advantageous to borrow in order to fund tax-favored saving vehicles. To the extent that borrowing occurs to fund these accounts, no net saving occurs. Ideally, saving incentives should apply only to net new saving, in order to avoid windfall gains to existing savings. However, measuring net new saving would be difficult in practice.

Others have argued that increasing the return to savings (by not taxing earnings) might cause some taxpayers actually to save less, as a higher return to savings means that less saving is necessary to achieve a "target" level of savings at some point in the future.

Both LSAs and RSAs receive tax treatment generally equivalent to Roth IRAs. While the taxpayer does not deduct contributions to LSAs, tax is never paid on the income earned on the investment. The same is generally true for RSAs as long as amounts are withdrawn in qualified distributions. However, while LSAs and RSAs receive tax treatment similar to Roth IRAs, an individual's combined maximum allowable annual contribution to RSAs and LSAs is greater than the amount of contributions currently permitted to Roth IRAs. The increase in the amounts that may be contributed to tax-preferred savings accounts provides a tax incentive for further saving for those who have already contributed the maximum to existing tax-favored savings accounts. However, for taxpayers not already contributing the maximum amounts, the new accounts provide no additional economic inducement to save, except to the extent that the LSAs provide withdrawal flexibility relative to existing retirement savings vehicles' age restrictions.[30] Opponents of proposals to increase tax-favored saving thus argue that the only beneficiaries are likely to be wealthy taxpayers with existing savings that will be shifted to the tax-favored accounts, since most taxpayers have not taken full advantage of existing saving incentives.

Tax free distributions from Roth IRAs have created an incentive for some taxpayers to transfer value into a Roth IRA that is not legitimately characterized as return on investment for

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[29] *See* Karen C. Burke and Grayson M.P. McCouch, *Lipstick, Light Beer, and Backloaded Savings Accounts*, 25 VA. TAX REV. 1101, 1139 (Spring 2006). Also, unlike present-law IRAs, an LSA does not require that contributions be no greater than compensation. Under the proposal, regardless of income, an individual may make nondeductible annual contributions to an LSA of up to $2,000. To the extent an individual makes contributions to his or her own LSA that exceed his or her income, then the amounts transferred in excess of income must represent a transfer of assets from existing savings and not new savings from forgoing current consumption. Additionally, individuals other than the LSA owner may make contributions to an LSA.

[30] Some argue that contributions to deductible IRAs declined substantially after 1986 for taxpayers whose eligibility to contribute to deductible IRAs was not affected by the income-related limits introduced in 1986, because financial institutions cut back on promoting contributions as a result of the general limits on deductibility. Thus, they argue, universally available tax-preferred accounts such as LSAs and RSAs will increase saving at all income levels. It is also argued that, to the extent that the LSA's withdrawal flexibility provides a new tax incentive for savings for any purpose, LSAs will provide an additional economic inducement to save.

the assets held by the Roth IRA but rather is a disguised additional contribution. In most cases, the transfer is structured to use the tax exempt status of the Roth IRA to also avoid current income tax liability by the individual on the amount transferred.[31] Expanding the opportunity to make contributions to savings vehicles that receive tax treatment similar to Roth IRAs may increase the occurrence of these abuses and the need for IRS enforcement efforts to combat them.

RSAs also replace traditional IRAs and thereby eliminate taxpayers' ability to make deductible contributions. From an economic perspective, RSAs receive tax treatment generally equivalent to a traditional IRAs to which deductible contributions are made.[32] Some argue that the upfront deduction provides a greater psychological inducement to save, and that the elimination of traditional IRAs may reduce saving by those who would have been able to make deductible contributions. Another difference between RSAs and traditional IRAs is that RSAs are not subject to lifetime required minimum distributions. Arguably, this allows an RSA to be

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[31] Notice 2004-8, 2004-1 CB 333, describes certain abusive Roth transactions that involve this type of transfer of value and identifies the transactions as "listed transactions." The preamble to TD 9220, Converting an IRA Annuity to a Roth IRA, 70 FR 48868, published August 22, 2005, describes transactions in which taxpayers have attempted to structure conversions of a traditional IRA annuity to a Roth IRA annuity to permit including in gross income less than the fair market value of the traditional IRA annuity on the date of the conversion.

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

Also, the economic equivalence of saving in an RSA or a traditional deductible IRA does not mean that a dollar contributed to an RSA is the economic equivalent of a dollar contributed to a deductible IRA. The reason is that a given dollar contribution to an RSA requires a greater reduction in current consumption (since the contribution is not deductible), and thus represents more saving than the same dollar contribution to a deductible IRA. For example, a taxpayer in the 25 percent tax bracket must reduce current consumption by $2,000 to contribute $2,000 to an RSA, but only by $1,500 to contribute $2,000 to a deductible IRA, because the $2,000 contribution reduces current tax liability by 25 percent of $2,000, or $500. Thus, the proper economic comparison of the tax benefits of the two types of tax-favored saving is the comparison of a $1,500 RSA contribution to $2,000 deductible IRA. To then see the equivalence of these, note that if the respective investments doubled in value prior to withdrawal, the $1,500 RSA would grow to $3,000, and be worth $3,000 after taxes when withdrawn, since no tax is due upon withdrawal. The $2,000 deductible IRA would grow to $4,000, but after the 25 percent tax is levied, the after tax value would be $3,000, the same as for the RSA. More generally, the final after-tax value of the contribution to the deductible IRA is given by $C * (1+r)^n * (1-t)$, where C equals the contribution, r the annual rate of return, n the number of years the investment is held, and t the tax rate. The final after-tax value of the equivalent RSA contribution is $(1-t) * C * (1+r)^n$. Note that the only difference in the two expressions is the location of the $(1-t)$ term, and thus the expressions are mathematically equivalent.

used primarily as an estate planning device rather than a retirement savings vehicle. However, a counter argument is that this feature allows larger amounts to be retained in tax free savings until needed. Thus, larger amounts can be saved for higher late-in-life expenses, such as long term care.

Taxpayers may convert balances under Coverdell education savings accounts and qualified tuition programs into LSAs on a tax-free basis before January 1, 2009. Under the proposal, existing balances in Coverdell education savings accounts and existing balances in qualified tuition programs (up to $50,000) may be converted to LSA balances with no income tax consequences. This means that pretax earnings accumulated on Coverdell education savings accounts and qualified tuition program balances that are converted to LSAs may be withdrawn and spent for purposes other than education without the income tax consequences applicable to Coverdell education savings account and qualified tuition program distributions that are used for nonqualifying expenses. Conversion allows the consolidation of saving into a single vehicle for simplification purposes. However, there is some scope for abuse of this conversion option. A taxpayer with sufficient resources may effect such a conversion simply to shift more saving into tax-favored accounts. For example, a taxpayer could transfer $50,000 from an existing qualified tuition program into an LSA, thus insulating already accumulated earnings from tax, regardless of whether they are used for education expenses, and then reinvest a different $50,000 into the qualified tuition program. This reinvestment could be prevented by requiring that the amount transferred continue to be taken into account in determining whether the taxpayer's account under the program from which the amount was transferred satisfies the prohibition against excess contributions.[33]

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

Some argue that offering RSAs and LSAs will reduce the incentive for small business owners to maintain qualified retirement plans for themselves and their employees. A business owner can generally contribute more to a qualified plan than the contributions that may be made to RSAs and LSAs, but only if comparable contributions are made by or on behalf of rank-and-file employees. The business owner must therefore successfully encourage rank-and-file

[33] Sec. 529(b)(6), which requires that a qualified tuition program have adequate safe guards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for higher education expenses of the beneficiary. However, this solution might have a limited effect because there is no uniform Federal limit on the amount that can be contributed to a qualified tuition program. Instead, each State sets its own limit on the amount that is permitted to be contributed without violating this prohibition against excess contributions.

employees to contribute to the plan or, in many cases, make matching or nonelective contributions for rank-and-file employees. The opportunity to make annual contributions to both an RSA and an LSA for both the business owner and his or her spouse, without regard to adjusted gross income or contributions for rank-and-file employees, may be a more attractive alternative to maintaining a qualified retirement plan. Others argue that many employers (including small employers) offer qualified retirement plans to attract and retain high-quality employees and will continue to do so. Some raise concerns that, as a substitute for a qualified retirement plan, an employer could selectively choose to pay additional compensation only to highly compensated employees in the form of contributions to RSAs and LSAs. This may undermine the principle of promoting savings for rank-and-file employees.

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

Prior Action

A similar proposal was included in the President's fiscal year 2005, 2006, 2007, and 2008 budget proposals, except that, in the proposals for years before 2008, the annual dollar limit on contributions to LSAs was $5,000. The President's fiscal year 2004 budget proposal included a similar proposal; among the differences is that, in the fiscal year 2004 proposal, the annual dollar limit on contributions to RSAs or to LSAs was $7,500.

2. Consolidation of employer-based savings accounts

Present Law

In general

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

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

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to be qualified and for favorable tax treatment to apply. These requirements include nondiscrimination rules that are intended to ensure that a qualified retirement plan covers a broad group of employees. Certain of these rules are discussed in more detail below.

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

In addition to qualified section 401(k) plans, present law provides for other types of employer-sponsored plans to which pretax employee elective contributions can be made. Many of these arrangements are not qualified retirement plans, but receive the same tax-favored treatment as qualified retirement plans. The rules applicable to each type of arrangement vary. These arrangements include tax sheltered annuity plans ("section 403(b)" plans),[34] governmental eligible deferred compensation plans ("section 457" plans), [35] SIMPLE IRAs,[36] and salary-reduction simplified employee pensions ("SARSEPs").[37]

Limits on contributions to qualified defined contribution plans

The annual additions under a defined contribution plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation ($46,000 for 2008). Annual additions are the sum of employer contributions,[38] employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Nondiscrimination requirements applicable to qualified retirement plans

The nondiscrimination requirements are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.[39]

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[34] Sec. 403(b).

[35] Sec. 457.

[36] Sec. 408(p). There is a parallel safe harbor simple plan design for qualified section 401(k) plans for small employers in section 401(k)(11).

[37] Sec. 408(k).

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

[39] Sections 401(a)(3) and 410(b) provide a test for determining if the group of employees covered under a qualified plan is too heavily weighted in favor of highly compensated employees. The test generally compares the percentage of highly compensated employees of the employer covered under

Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.[40] Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules. Under the regulations, the amount of contributions or benefits provided under the plan, and the benefits, rights and features offered under the plan, must be tested.[41]

Treasury regulations provide three general approaches to testing the amount of nonelective contributions provided under a defined contribution plan: (1) design-based safe harbors; (2) a general test; and (3) cross-testing.[42] Elective deferrals, matching contributions, and after-tax employee contributions are subject to separate testing as described below.

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

In general

Section 401(k) plans are subject to the rules generally applicable to qualified defined contribution plans.[43] In addition, special rules apply.

As described above, an employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an individual is $15,500 (for 2008). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan. As a result, the dollar limit on elective deferrals is increased for an individual who has attained age 50 by $5,000 (for 2008). An employee's elective deferrals must be fully vested.

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the plan to the percentage of nonhighly compensated employees of the employer covered under the plan. For purposes of this coverage test and other nondiscrimination requirements, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $105,000 (for 2008) or (b) at the election of the employer had compensation for the preceding year in excess of $105,000 (for 2008) and was in the top 20 percent of employees by compensation for such year (sec. 414(q)). A nonhighly compensated employee is an employee other than a highly compensated employee.

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

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

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

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

Special nondiscrimination tests

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test (the "ADP" test).[44] The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

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

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a "safe harbor" section 401(k) plan).[45] A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. The required matching contributions and the three percent nonelective contribution must be immediately nonforfeitable (i.e., 100 percent vested) when made.

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

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

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

rate of matching contribution with respect to the same rate of elective deferral of a nonhighly compensated employee.

Another safe harbor applies in the case of a section 401(k) plan that is a qualified automatic contribution arrangement, i.e., that provides for elective deferrals at specified rates to be made on behalf of an employee unless the employee elects otherwise.[46] A lower rate of matching contribution is required under this safe harbor: (1) 100 percent of the employee's elective deferrals up to one percent of compensation and (2) 50 percent of the employee's elective deferrals from two to six percent of compensation. In addition, the matching and nonelective contributions are only required to be vested after the completion of two years of service rather than being immediately nonforfeitable.

Nondiscrimination tests for matching contributions and after-tax employee contributions

Employer matching contributions and after-tax employee contributions are also subject to a special annual nondiscrimination test (the "ACP test").[47] The ACP test compares the actual contribution percentages ("ACPs") of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

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

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

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[46] Sec. 401(k)(13).

[47] Sec. 401(m).

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

Section 403(b) plans are another form of employer-based retirement plan that provide the same tax benefits as qualified retirement plans. Employers may contribute to such plans on behalf of their employees, and employees may make elective deferrals. Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.[48]

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals and catch-up contributions under a section 401(k) plan. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the contributions under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, additional elective deferrals are permitted under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service.

Section 403(b) plans are generally subject to the minimum coverage and general nondiscrimination rules that apply to qualified defined contribution plans. In addition, employer matching contributions and after-tax employee contributions are subject to the ACP test.[49] However, pretax contributions made by an employee under a salary reduction agreement (i.e., elective deferrals) are not subject to nondiscrimination rules similar to those applicable to elective deferrals under section 401(k) plans. Instead, all employees generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.

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

Compensation deferred under a section 457 plan of a State or local governmental employer is includible in income when paid.[50] The maximum annual deferral under such a plan generally is the lesser of (1) $15,500 (for 2008) or (2) 100 percent of compensation. A special,

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[48] For proposals to provide greater conformity between section 403(b) and section 401(k) plans, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, Part IV.E, at 122-129.

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

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

higher limit applies for the last three years before a participant reaches normal retirement age (the "section 457 catch-up limit"). In the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of $5,000 (for 2008), unless a higher section 457 catch-up limit applies. Only contributions to section 457 plans are taken into account in applying these limits; contributions made to a qualified retirement plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457 plan for that employee. Thus, for example, a State or local government employee covered by both a section 457 plan and a section 401(k) or 403(b) plan can contribute up to $15,500 (for 2008) to each plan for a total of $31,000.

SIMPLE retirement plans

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

A SIMPLE retirement plan allows employees to make elective deferrals, subject to a limit of $10,500 (for 2008). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE plan up to a limit of $2,500 (for 2008).

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

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

In the case of a SIMPLE IRA, the group of eligible employees generally must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. A SIMPLE IRA is not subject to the nondiscrimination rules generally applicable to qualified retirement plans. In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans under section 410(b). A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

Salary reduction simplified employee pensions (SARSEPs)

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to defined contribution plans. All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee (1) has attained age 21, (2) has performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $500 (for 2008) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a SARSEP (i.e., a salary reduction SEP) under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($15,500 for 2008). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $5,000 (for 2008).

Designated Roth contributions

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

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

A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made

after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

Description of Proposal

In general

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

Employer Retirement Savings Accounts

In general

The rules applicable to ERSAs generally follow the present-law rules for section 401(k) plans with certain modifications. Existing section 401(k) plans and thrift plans are renamed ERSAs and continue to operate under the new rules. Existing section 403(b) plans, governmental section 457 plans, SARSEPs, and SIMPLE IRAs and SIMPLE section 401(k) plans may be renamed ERSAs and operate under the new rules. Alternatively, such arrangements may continue to be maintained in their current form, but may not accept any new contributions after December 31, 2009.[51]

Types of contributions and treatment of distributions

An ERSA may provide for an employee to make pretax elective contributions and catch-up contributions up to the present-law limits applicable to a section 401(k) plan, that is, a limit of $15,500 for elective deferrals and $5,000 for catch-up contributions, as indexed for future years. An ERSA may also allow an employee to designate his or her elective contributions as Roth contributions or to make other after-tax employee contributions. An ERSA may also provide for matching contributions and nonelective contributions. Total annual contributions to an ERSA for an employee (i.e., employee and employer contributions, including elective deferrals) may not exceed the present-law limit of the lesser of 100 percent of compensation or $46,000, as indexed for future years.

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

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

Nondiscrimination requirements

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

A design-based safe harbor is available for an ERSA to satisfy the nondiscrimination test. Similar to the section 401(k) safe harbor under present law, under the ERSA safe harbor, the plan must be designed to provide all eligible nonhighly compensated employees with either (1) a fully vested nonelective contribution of at least three percent of compensation, or (2) fully vested matching contributions of at least three percent of compensation, determined under one of two formulas. The ERSA safe harbor provides new formulas for determining required matching contributions. Under the first formula, matching contributions must be made at a rate of 50 percent of an employee's elective contributions up to six percent of the employee's compensation. Alternatively, matching contributions may be made under any other formula under which the rate of matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions that would be made if matching contributions were made on the basis of the percentages described in the first formula. In addition, the rate of matching contribution with respect to any rate of elective contribution cannot be higher for a highly compensated employee than for a nonhighly compensated employee.

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

Special rule for small employers

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

Effective date

The proposal is effective for years beginning after December 31, 2008.

Analysis

In general

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

The rules governing employer-sponsored retirement plans, particularly the nondiscrimination rules, are generally regarded as complex.[52] Some have argued that this complexity deters employers from establishing qualified retirement plans or causes employers to terminate such plans. Others assert that the complexity of the rules governing employer-sponsored retirement plans is a necessary byproduct of attempts to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer and to provide employers, particularly large employers, with the flexibility needed to recognize differences in the way that employers do business and differences in workforces.

Analysis of ERSA proposal

General nondiscrimination test

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

Some argue that the present-law nondiscrimination rules are unnecessarily complex and discourage employers from maintaining retirement plans. By reducing the complexity associated

[52] For a detailed discussion of complexity issues related to retirement savings, see, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

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

ERSA safe harbor

The present law safe harbors for elective deferrals and matching contributions were designed to achieve the same objectives as the special nondiscrimination tests for these amounts, but in a simplified manner. The alternative of a nonelective contribution of three percent ensures a minimum benefit for all employees covered by the plan, while the alternative of matching contributions at a higher rate (up to four percent) was believed to be sufficient incentive to induce participation by nonhighly compensated employees. It was also hoped that the safe harbors would reduce the complexities associated with qualified plans, and induce more employers to adopt retirement plans for their employees.

To the extent that the ERSA safe harbor requires an employee's elective deferrals to be matched at only a 50 percent rate and requires a total of only three percent in matching contributions, some argue that the proposal not only weakens the matching contribution alternative under the safe harbor, but also makes that alternative clearly less expensive for the employer than the nonelective contribution alternative, thereby reducing the incentive for an employer to provide nonelective contributions.[53] In addition, because, as under the present-law safe harbor, the matching contribution alternative is satisfied by offering matching contributions (without regard to the amount actually provided to nonhighly compensated employees), some argue that employers may no longer have a financial incentive to encourage employees to participate. This may reduce participation by rank-and-file employees. The proposal also does not provide a separate, more attractive, safe harbor for automatic enrollment arrangements (which tend to increase participation by rank-and-file employees).

The argument may also be made that the matching contribution requirement under the ERSA safe harbor is less rigorous than the matching contribution requirement that applies to a SIMPLE plan under present law, even though an ERSA is not subject to the limitations on

[53] The rates of matching contributions required under the proposal is also lower than the rates applicable for years after 2007 under the safe harbor for qualified automatic contribution arrangements.

SIMPLE arrangements (i.e., contributions are subject to lower limits and SIMPLEs are available only to small employers). In addition, an ERSA is only required to satisfy the coverage requirements of section 410(b) applicable to qualified plans generally rather than the stricter coverage requirement applicable to a SIMPLE IRA plan. On the other hand, some believe that the present-law safe harbor for section 401(k) plans has failed to provide an adequate incentive for employers to offer retirement plans to their employees and further incentive is needed. Some argue that the proposal makes the safe harbor more attractive for employers, especially small employers, and will thus increase coverage and participation.

Consolidation of various types of employer-sponsored plans

One of the sources of complexity in the present-law rules relating to employer-sponsored retirement plans is the existence of numerous vehicles with similar purposes but different rules.[54] Thus, employers desiring to adopt a retirement plan must determine which vehicles are available to that employer and which of the various vehicles available it wishes to adopt. This determination may entail a costly and time-consuming analysis and comparison of a number of different types of plans. By providing only one type of defined contribution plan to which employee contributions may be made, i.e., an ERSA, the proposal makes it easier for employers to determine whether to adopt a plan and what type of plan to provide. Having a single type of plan may also make it easier for employees to understand their retirement benefits, particularly when employees change jobs.

On the other hand, many employers already have plans and are familiar with the present-law rules applicable to their plans. Converting a present-law arrangement to an ERSA will involve administrative costs, which some employers may not view as commensurate with simplification benefits.

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

Under present law, amounts deferred under governmental section 457 plans are subject to an annual limit separate from the limit applicable to amounts deferred under section 401(k) and section 403(b) plans. By eliminating section 457 plans as a separate type of plan, the proposal eliminates the separate limit. Thus, State and local government employees, like other employees, would be subject to a single deferral limit. In this regard, the proposal furthers consistency and equity in the tax rules. However, some may consider it appropriate to allow

[54] This issue is discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, at Vol. II, Part III.A.1 (General simplification issues, at 149-150) and Part III.C.5 (Sources of Complexity, at 186), and in Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), Jan. 2005, Part IV.E, at 122-129.

State and local government employees to make higher deferrals than other types of employees as permitted under present law.

Some may be concerned that the proposal, in combination with the proposals for expanded individual savings opportunities (i.e., Lifetime Savings Accounts and Retirement Savings Accounts), will further reduce the incentive for small employers to offer retirement plans to their employees.[55] Although higher contributions may be made to an employer-sponsored retirement plan than to these other arrangements, comparable contributions must be made by or on behalf of rank-and-file employees. The opportunity to contribute a total of $7,000 a year to a Lifetime Savings Account and a Retirement Savings Account for both the business owner and his or her spouse, without regard to adjusted gross income or contributions for rank-and-file employees, may be a more attractive alternative to maintaining a qualified retirement plan. On the other hand, the excludability of ERSA contributions and the availability of the ERSA safe harbor, coupled with the higher contribution levels permitted under a qualified plan, may be viewed as providing an adequate incentive for a small employer to establish an ERSA.

Prior Action

A similar proposal was included in the President's fiscal year 2004, 2005, 2006, 2007, and 2008 budget proposals. The President's fiscal year 2004 budget proposal also included several proposals to simplify the rules for defined contribution plans generally.

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

B. Increase in Limitations on Expensing of Certain Depreciable Business Assets

Present Law

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.[56] For taxable years beginning in 2008, the maximum amount that a taxpayer may expense is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000.[57] For taxable years beginning in 2009 and 2010, the maximum amount that a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[58]

For taxable years beginning in 2011 and thereafter, other rules apply.[59]

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[56] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[57] The temporary $250,000 and $800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185.

[58] Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

[59] Under the rules in effect for taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year

Description of Proposal

The proposal increases permanently the amount a taxpayer may deduct under section 179. The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2008, is $200,000 of the cost of qualifying property placed in service for the taxable year. The $200,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000.

The President's fiscal 2009 budget proposal separately proposes permanent extension of the temporary provisions of section 179.[60] That proposal is treated as underlying the increased dollar amounts of this proposal. Under the permanent extension, the $200,000 and $800,000 amounts are indexed for inflation for taxable years beginning after 2009. In addition, off-the-shelf computer software is treated as qualifying property. Further, a taxpayer is permitted to make or revoke an election for a taxable year under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year.

Effective date.–The proposal is effective for taxable years beginning after 2008.

Analysis

The proposal lowers the after-tax cost of capital expenditures made by businesses within a certain size range by permitting the immediate depreciation of the full amount of the capital expenditure (i.e., expensing), rather than depreciation of the expenditure over the recovery period. With a lower cost of capital, it is argued that eligible businesses will invest in more equipment and employ more workers, thus serving to stimulate economic growth among businesses taxable in the United States.

Expensing of capital investments is the appropriate treatment if the objective is to tax consumption, because expensing effectively eliminates tax on the returns to investment, subject to certain assumptions.[61] If the objective is to tax income, then depreciation deductions should

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exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner (sec. 179(c)(2)).

[60] *See* section I.A. of this document for the description of the President's fiscal 2009 budget proposal permanently extending the temporary rules of section 179.

[61] To see this, consider an investment of $100 that yields a $10 return in the following year, i.e., a 10-percent pre-tax return. If the tax rate is 50 percent, expensing of the $100 investment yields a $50 reduction in tax liability, meaning the after-tax cost to the taxpayer for the $100 investment is $50. The $10 return in the following year results in a $5 tax, and thus a $5 after-tax return. Thus, the after-tax return on the investment is 10 percent (5 divided by 50), the same as the pre-tax return. To fully effect consumption tax treatment, other modifications would need to be made, such as not imposing capital gains taxes with respect to sales of business equity interests and fully integrating the corporate and individual tax systems. Additionally, no business interest expense deductions could be permitted or negative effective tax rates would result. Finally, even with the changes above, any property taxes

coincide with the economic depreciation of the asset in order to measure economic income accurately. A depreciation system more generous than economic depreciation, but less generous than full expensing, results in an effective tax rate on the income from capital that is less than the statutory tax rate.

In addition to promoting investment, advocates of expensing assert that increased expensing eliminates depreciation recordkeeping requirements with respect to expensed property. Under the proposal, Federal income tax accounting could be simplified by increasing the portion of capital costs that are expensed in one taxable year and concomitantly reducing those that are recovered through depreciation over the recovery period. It could be argued that the simplification benefit of expensing is not fully realized, however, so long as property is partially depreciated, or so long as some but not all of the taxpayer's property that is eligible for cost recovery is expensed; the taxpayer must still keep records for that property that is subject to depreciation over a period of years.

The proposal increases the present-law $400,000 phaseout threshold amount to $800,000, which has the effect of generally permitting larger businesses to obtain the tax benefit of expensing. Some may argue that this result is inconsistent with the idea of limiting expensing to small businesses, as under the present-law provision. They might alternatively argue that in an income tax system, expanding the availability of expensing is not appropriate because it results in more severe mismeasurement of economic income. On the other hand, it could be argued that there is no rationale for limiting expensing to businesses below a particular size or with capital expenditures below a certain level.

An advantage of making the increase in the expensing amounts permanent is that it reduces uncertainty with respect to the tax treatment of future investment, thus permitting taxpayers to plan capital expenditures with greater focus on the underlying economics of the investments, and less focus on tax-motivated timing of investment. Removing tax-motivated distortions in the timing of investment may promote more efficient allocation of economic resources. On the other hand, legislative changes to the expensing rules (principally temporary increases in the amount that can be expensed) have been frequent in the past decade, and there is nothing to suggest that additional legislative changes would not be made to the expensing rules, whether the current expensing rules were permanent or temporary. Additionally, to the extent that the rationale for the original increase in the amounts that may be expensed was to provide a counter-cyclical short-term economic stimulus, it can be argued that it is important that such provisions in fact be temporary. If there is uncertainty that a provision providing temporary tax relief may not ultimately be temporary, it can be argued that the stimulative effect of the provision is compromised because the taxpayer need not act within the originally specified time frame of the provision in order to get the tax benefits from the provision.

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imposed at the State or local level would cause there to remain a positive effective tax rate on the return to investment.

Prior Action

A similar proposal was included in the President's budget proposals for fiscal years 2007 and 2008.

C. Provisions Relating to Health Care

1. Provide a standard deduction for health insurance

Present Law

Overview of tax treatment of health expenses

Present law includes a variety of provisions that provide tax benefits for health expenses. The specific tax treatment of such expenses depends in part on whether the taxpayer is covered under a health plan paid for by an employer, whether the taxpayer has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold. Individuals who are covered by a high deductible health plan are able to contribute to a health savings account ("HSA"). Certain limited classes of individuals are eligible to receive a refundable tax credit of 65 percent of the cost of health insurance coverage. Table 1, below, provides a comparison of the various tax provisions of present law. Each provision is discussed in more detail, below.

Exclusion for employer-provided accident and health coverage[62]

An employer's contribution to a plan providing health coverage for an employee and his or her spouse and dependents is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their share of premiums on a pre-tax basis through salary reduction. Such salary reduction contributions are treated as employer contributions and thus are also excluded from gross income and wages for payroll taxes. Reimbursements under an employer plan for medical expenses are also excludable from gross income and wages. There is no limit on the amount of employer-provided health coverage that is excludable.

The exclusion for employer-provided health coverage applies to medical expenses not covered by insurance as well as health insurance expenses. Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs").

[62] Secs. 104, 105, 106, 125, and 3121(a)(4).

Table 1.–Comparison of Present-Law Tax Benefits for Health Expenses[1]

Provision	Tax Benefit	Class Eligible	Maximum Dollar Limit on Tax Benefit	Qualified Costs/Expenses
1. Employer contributions to an accident or health plan (sec. 106)	Exclusion from gross income and wages.	Employees (including former employees).	No limit on amount excludable.	Contributions to health plan for the taxpayer, spouse and dependents.
2. Employer reimbursement of medical expenses (sec. 105)	Exclusion from gross income and wages.	Employees (including former employees).	No limit on amount excludable.	Medical care expenses (as defined under section 213(d)) of the taxpayer, spouse and dependents.
3. Employer-provided health benefits offered under a cafeteria plan (sec. 125)	Exclusion from gross income and wages (for salary reduction contributions).	Employees.	No limit on amount excludable.	Coverage under an accident or health plan (secs. 105 and 106).
4. Health reimbursement arrangements (secs. 105 and 106)	Employer-maintained arrangement providing exclusion from gross income and wages for amounts used to reimburse employees for medical expenses. Amounts remaining at the end of the year can be carried forward to reimburse medical expenses in later years. There is no tax-free accumulation of earnings.	Employees (including former employees).	No limit on amount excludable.	Medical care expenses (as defined under section 213(d)) of the taxpayer, spouse and dependents.
5. Health flexible spending arrangements (secs. 105, 106, and 125)	Employee salary-reduction arrangement providing exclusion from gross income and wages for amounts used to reimburse employees for medical expenses.	Employees.	No limit on amount excludable.	Medical care expenses (as defined under section 213(d)) of the taxpayer, spouse and dependents (but not premium payments for other health coverage).

[1] The table describes the legal limits that apply under present law. Employers may establish rules and limitations consistent with those under present law. For example, it is common for employers to place a limit on the amount of expenses that may be reimbursed through an FSA or HRA.

Provision	Tax Benefit	Class Eligible	Maximum Dollar Limit on Tax Benefit	Qualified Costs/Expenses
6. Deduction for health insurance expenses of self-employed individuals (sec. 162(l))	Income tax deduction for cost of health insurance expenses of self-employed individuals. Deduction does not apply for self-employment tax purposes.	Self-employed individuals.	No specific dollar limit; deduction limited by amount of taxpayer's earned income from the trade or business.	Insurance which constitutes medical care for the taxpayer, spouse and dependents.
7. Itemized deduction for medical expenses (sec. 213)	Itemized deduction for unreimbursed medical expenses to extent expenses exceed 7.5 percent of adjusted gross income (10 percent for alternative minimum tax purposes).	Any individual who itemizes deductions and had unreimbursed medical expenses in excess of 7.5 percent of adjusted gross income.	No maximum limit.	Expenses for medical care (as defined under section 213(d)) of the taxpayer, spouse and dependents. Medicine or drugs must be prescribed or insulin.
8. Health Savings Accounts ("HSAs") (sec. 223)	Contributions are deductible if made by an eligible individual and excluded from gross income and wages if made by an employer (including contributions made through a cafeteria plan through salary reduction). Distributions used for qualified medical expenses excludable from gross income. Earnings on amounts in the HSA accumulate on a tax-free basis.	Individuals with a high deductible health plan and no other health plan other than a plan that provides certain permitted coverage. High deductible health plan is a plan with a deductible of at least $1,100 for self-only coverage and $2,200 for family coverage (for 2008). Out-of-pocket expense limit must be no more than $5,600 for self-only coverage and $11,200 for family coverage (for 2008).	Maximum annual contribution is $2,900 for self-only coverage or $5,800 for family coverage (for 2008). Additional contributions permitted for individuals age 55 or older. No limit on the amount that can be accumulated in the HSA.	Qualified medical expenses include those for medical care (as defined under section 213(d)), but do not include expenses for insurance other than certain limited exceptions.

Provision	Tax Benefit	Class Eligible	Maximum Dollar Limit on Tax Benefit	Qualified Costs/Expenses
9. Archer Medical Savings Accounts ("Archer MSAs") (sec. 220)	Contributions are deductible if made by an eligible individual and excluded from gross income and wages if made by an employer. Distributions used for qualified medical expenses are excludable from gross income. Earnings on amounts in the Archer MSA accumulate on a tax-free basis.	Employees of small employers who are covered under an employer-sponsored high-deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) and self-employed individuals covered under a high-deductible health plan. Definition of high-deductible health plan differs from that for HSAs. No new contributions may be made after 2007 except for individuals who previously had an MSA or work for an employer that made MSA contributions.	Maximum annual contribution is 65 percent of the annual deductible under the high-deductible health plan in the case of self-only coverage, and 75 percent of the annual deductible in the case of family coverage. No limit on the amount that can be accumulated in the MSA.	Qualified medical expenses include those for medical care as defined under section 213(d), but do not include expenses for insurance other than certain limited exceptions.
10. Health Coverage Tax Credit (sec. 35)	Refundable tax credit of 65 percent of the cost of qualified health insurance coverage.	Individuals receiving trade adjustment assistance and certain individuals receiving benefits from the PBGC.	Limited to 65 percent of the cost of qualified health insurance. No specific dollar limit.	Qualified health insurance as defined in section 35(e).

Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, the compensation that is forgone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the requirements relating to cafeteria plans generally, including a requirement that a cafeteria plan generally may not provide deferred compensation.[63] This requirement is often referred to as the "use-it-or-lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts remaining in a health FSA as of the end of a plan year must be forfeited by the employee. In May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.[64] Health FSAs are subject to certain other requirements, including rules that require that the FSA have certain characteristics similar to insurance.

Health reimbursement arrangements ("HRAs") operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year.[65]

Exclusion for distributions from governmental retirement plans for health insurance premiums for public safety officers[66]

Effective for taxable years beginning after December 31, 2006, present law provides an exclusion from income for distributions from governmental retirement plans that are used to pay for health insurance premiums for eligible retired public safety officers and their spouses and dependents. The exclusion is limited to $3,000 annually. An eligible retired safety officer is an individual who, by reason of disability or attainment of normal retirement age, is separated from service as a public safety officer with the employer who maintains the retirement plan from which the distributions are made. The premiums do not have to be for a plan sponsored by the employer; however, the exclusion does not apply to premiums paid by the employee and reimbursed with pension distributions. Amounts excluded under this provision are not taken into account in determining the itemized deduction for medical expenses or the deduction for health insurance expenses of self-employed individuals.

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[63] Sec. 125(d)(2).

[64] Notice 2005-42, 2005-23 I.R.B. 1204.

[65] Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case of an individual covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

[66] Sec. 402(l).

Deduction for health insurance expenses of self-employed individuals[67]

Self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. The deduction may not exceed the individual's self-employment income. The deduction applies to the cost of insurance, i.e., it does not apply to out-of-pocket expenses. The deduction does not apply for self-employment tax purposes. For purposes of the deduction, more than two-percent shareholder-employees of an S corporation are treated the same as self-employed individuals.[68] Thus, the exclusion for employer-provided health coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self employed.

Itemized deduction for medical expenses[69]

Individuals may claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 7.5 percent of adjusted gross income.[70] Thus, an individual (other than a self-employed individual) may deduct health insurance premiums only to the extent that aggregate unreimbursed medical expenses exceed 7.5 percent of adjusted gross income.

Refundable credit for health insurance expenses of certain classes of individuals[71]

Under the Trade Adjustment Assistance Reform Act of 2002,[72] certain individuals are eligible for the health coverage tax credit ("HCTC"). The HCTC is a refundable tax credit equal to 65 percent of the cost of qualified health coverage paid by an eligible individual. In general, eligible individuals are individuals receiving a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 and receiving pension benefits from the Pension Benefit Guaranty Corporation. The credit is available for "qualified health insurance," which includes certain employer-based insurance, certain State-based insurance, and in some cases, insurance purchased in the individual market. The credit is available on an advance basis through a program established by the Secretary of the Treasury. Persons entitled to Medicare

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[67] Sec. 162(l).

[68] Sec. 1372.

[69] Sec. 213.

[70] For alternative minimum tax purposes, the itemized deduction is calculated using a floor of 10 percent of adjusted gross income. Sec. 56(b)(1)(B).

[71] Sec. 35.

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

and certain other governmental health programs, covered under certain employer-subsidized plans, or with certain other specified coverage are not eligible for the credit.[73]

Health savings accounts[74]

Present law provides that individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage)[75] may establish an HSA. An HSA is a tax-exempt trust or custodial account. Subject to certain limitations, contributions made to an HSA by an individual are deductible above-the-line for income tax purposes and contributions made by an employer (including contributions made through a cafeteria plan through salary reduction) are excludable from income and wages. Earnings on amounts in an HSA accumulate on a tax-free basis. Distributions from an HSA that are for qualified medical expenses are excludable from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent. However, the additional 10-percent tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). Thus, HSAs provide the opportunity to pay for current out-of-pocket medical expenses on a tax-favored basis, as well as the ability to save for future medical and nonmedical expenses on a tax-favored basis. To the extent that amounts in an HSA are not used for qualified expenses, an HSA provides tax benefits similar to an individual retirement arrangement ("IRA").[76]

Qualified medical expenses generally are defined as under section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long-term care expenses. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an

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[73] Sec. 35(f).

[74] Sec. 223.

[75] An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Effective after December 20, 2006, with respect to coverage for years beginning after December 31, 2006, certain coverage under an FSA is disregarded in determining eligibility for an HSA.

[76] Other tax-favored vehicles may also be used to save for future medical expenses, but do not provide the same tax benefits. For example, funds in an IRA may be used to pay medical expenses, but distributions for medical expenses are includible in gross income to the same extent as other IRA distributions.

individual is receiving unemployment compensation under Federal or State law, and (4) premiums for individuals who have attained the age of Medicare eligibility, other than premiums for Medigap policies.

A high deductible health plan is a health plan that has a deductible that is at least $1,100 for self-only coverage or $2,200 for family coverage (for 2008) and that has an out-of-pocket expense limit that is no more than $5,600 in the case of self-only coverage and $11,200 in the case of family coverage (for 2008).[77]

For 2008, the maximum aggregate annual contribution that can be made to an HSA is $2,900 in the case of self-only coverage and $5,800 in the case of family coverage.[78] The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year (referred to as "catch up contributions"). In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $900 in 2008, and $1,000 in 2009 and thereafter. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period. The comparability rule does not apply to contributions made through a cafeteria plan.

Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

One-time rollovers are permitted from IRAs to HSAs for taxable years beginning after December 31, 2006.

Archer medical savings accounts[79]

Like HSAs, an Archer medical savings account ("MSA") is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. Archer MSAs provide tax benefits similar to, but generally not as

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[77] These amounts are indexed for inflation.

[78] These amounts are the same as the maximum deductible amounts permitted under a high deductible plan for purposes of Archer medical savings accounts ("MSAs") and are indexed for inflation. In the case of individuals who are married to each other, if either spouse has family coverage, both spouses are treated as only having the family coverage with the lowest deductible and the contribution limit is divided equally between them unless they agree on a different division. Limitations based on the amount of the deductible under the high deductible plan applied to years beginning before January 1, 2007.

[79] Sec. 220.

favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for Archer MSA purposes, a high deductible health plan is a health plan with (a) an annual deductible of at least $1,950 and no more than $2,900 in the case of self-only coverage and at least $3,850 and no more than $5,800 in the case of family coverage and (b) maximum out-of pocket expenses of no more than $3,850 in the case of self-only coverage and no more than $7,050 in the case of family coverage;[80] and (3) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

Definition of medical care

For purposes of the itemized deduction for medical expenses, section 213(d) defines "medical care" to mean amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to medical care referred to in (1); (3) qualified long-term care services; and (4) insurance covering medical care referred to in (1) or (2), or for eligible long-term care premiums for a qualified long-term care insurance contract.[81] Expenditures for items that are merely beneficial to the general health of an individual, such as expenditures for vacations or vitamins, are not medical care. Expenditures for "medicines and drugs" are medical care. Toiletries (e.g., toothpaste), cosmetics (e.g., face creams), and sundry items are not "medicines and drugs" and amounts expended for such items are not expenditures for "medical care." In general, cosmetic surgery and similar procedures do not constitute medical care.

For purposes of the exclusions for reimbursements under employer accident and health plans and distributions from HSAs, the limitation (applicable to the itemized deduction) that only prescription medicines or drugs and insulin are taken into account does not apply. Thus, for example, amounts paid from an FSA, HRA, or HSA to reimburse the employee for nonprescription medicines, such as sunscreen, nonprescription aspirin, allergy medicine, antacids, or pain relievers, are excludable from income; however, if the employee paid for such amounts directly (without such reimbursement), the expenses could not be taken into account in determining the itemized deduction for medical expenses.

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[80] These deductible and out-of-pocket expenses dollar amounts are for 2008. These amounts are indexed for inflation in $50 increments.

[81] Sec. 213(d). The amount of long-term care premiums that may be taken into account for purposes of the itemized deduction is subject to a dollar limit based on the age of the covered individual.

Long-term care insurance and expenses

Tax treatment

Present law provides favorable tax treatment for qualified long-term care insurance contracts and expenses for qualified long-term care services.

A qualified long-term care insurance contract is treated as an accident and health insurance contract.[82] Amounts received under the contract generally are excludable from income as amounts received for personal injuries or sickness.[83] In the case of per diem contracts, the excludable amount is subject to a dollar cap of $260 per day (for 2007), as indexed. If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of costs in excess of the dollar cap that are incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to the rules relating to return of basis under section 72.

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan (benefits under which generally are excludable from the recipient's income under section 105). This exclusion does not apply to long-term care insurance provided under a cafeteria plan.

Premiums paid for a qualified long-term care insurance contract, subject to a dollar cap on the deductible amount of the premium per year based on the insured person's age at the end of the taxable year, and unreimbursed expenses for qualified long-term care services are treated as medical expenses for purposes of the itemized deduction for medical care. Medical expenses generally are allowed as a deduction only to the extent they exceed 7.5 percent of adjusted gross income.[84]

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the floor of 7.5 percent of adjusted gross income).

Long-term care insurance expenses of a self-employed individual are deductible under the self-employed health deduction.[85]

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[82] Sec. 7702B(a)(1).

[83] Sec. 104(a)(3).

[84] Sec. 213(a).

[85] Sec. 162(l).

Definitions

A qualified long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services, and that meets additional requirements.[86] The contract is not permitted to provide for a cash surrender value or other money that can be paid, assigned or pledged as collateral for a loan, or borrowed (and premium refunds are to be applied as a reduction in future premiums or to increase future benefits). Per diem-type and reimbursement-type contracts are permitted.

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner.[87]

A chronically ill individual is generally one who has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform (without substantial assistance) at least two activities of daily living (ADLs) for at least 90 days due to a loss of functional capacity (or meeting other definitional requirements).[88]

Earned income credit

In general

Low and moderate-income workers may be eligible for the refundable earned income credit (EIC). Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The earned income credit generally equals a specified percentage of earned income[89] up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI)), if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with

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[86] Sec. 7702B(b).

[87] Sec. 7702B(c)(1).

[88] Sec. 7702B(c)(2).

[89] Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,950 (for 2008). This threshold is indexed. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year shall not be considered as married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,[90] and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

The EIC is available to low and moderate-income working taxpayers. Three separate schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, and one schedule for taxpayers with more than one qualifying child.[91]

Taxpayers with one qualifying child may claim a credit in 2008 of 34 percent of their earnings up to $8,580, resulting in a maximum credit of $2,917. The maximum credit is available for those with earnings between $8,580 and $15,740 ($18,740 if married filing jointly). The credit begins to phase down at a rate of 15.98 percent of earnings above $15,740 ($18,740 if married filing jointly). The credit is phased down to $0 at $33,995 of earnings ($36,995 if married filing jointly).

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[90] A foster child must reside with the taxpayer for the entire taxable year.

[91] All income thresholds are indexed for inflation annually.

Taxpayers with more than one qualifying child may claim a credit in 2008 of 40 percent of earnings up to $12,060, resulting in a maximum credit of $4,824. The maximum credit is available for those with earnings between $12,060 and $15,740 ($18,740 if married filing jointly). The credit begins to phase down at a rate of 21.06 percent of earnings above $15,740 ($18,740 if married filing jointly). The credit is phased down to $0 at $38,646 of earnings ($41,646 if married filing jointly).

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $5,720, resulting in a maximum credit of $438, for 2008. The maximum is available for those with incomes between $5,720 and $7,160 ($10,160 if married filing jointly). The credit begins to phase down at a rate of 7.65 percent of earnings above $7,160 ($10,160 if married filing jointly) resulting in a $0 credit at $12,880 of earnings ($15,880 if married filing jointly).

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EIC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EIC with respect to the qualifying child. The eligible taxpayer who does not claim the EIC with respect to the qualifying child may not claim the EIC for taxpayers without qualifying children.

Description of Proposal

New standard deduction for health insurance

The proposal provides a new standard deduction for health insurance ("SDHI") for individuals who are covered by qualified health insurance. The deduction applies with respect to coverage of the individual and his or her spouse and dependents. The SDHI applies for both income tax and employment tax purposes and is limited by earned income. The maximum annual amount of the deduction is $15,000 in the case of family coverage (that is, coverage of more than one person)[92] and $7,500 in the case of single coverage. The dollar amounts are indexed for inflation after 2008 in accordance with the consumer price index. The SDHI applies for alternative minimum tax purposes.

The amount of the SDHI is determined on a monthly basis based on the coverage as of the first day of the month. That is, one-twelfth of the applicable SDHI applies for each month of qualifying coverage, regardless of the cost of the coverage.

Health coverage that qualifies for the SDHI must meet certain minimum coverage requirements, including: (1) a limit on out-of-pocket exposure for covered expenses that is not higher than that currently allowable for HSAs (e.g., for 2008, $5,600 for single coverage and $11,200 for family coverage); (2) a reasonable annual and/or lifetime benefit maximum; (3) coverage for inpatient and outpatient care, emergency benefits, and physician care; and (4) guaranteed renewability by the provider. The minimum level of coverage is not intended to preempt State laws mandating certain coverage. Thus, eligible coverage is subject to applicable

[92] In the case of a married taxpayer filing a separate return, the maximum deduction is $7,500.

State minimum coverage rules. Under regulations to be promulgated by the Department of Treasury, the SDHI would be denied for policies that do not meaningfully limit individual economic exposure to extraordinary medical expenses. Long-term care insurance and Medicare do not qualify for the SDHI.

An individual (including a dependent) enrolled in Medicaid or the State and Children's Health Insurance Program ("SCHIP") does not qualify for the SDHI. In general, individuals enrolled in Medicare do not qualify for the SDHI except that beginning on January 1, 2014, individuals enrolled in Medicare who are receiving health coverage as an active employee would be eligible for the SDHI. Individuals are not able to claim the SDHI if they claim the HCTC or pay for health insurance from an HSA or MSA. An individual who can be claimed as a dependent on another filer's return is not eligible to claim the SDHI.

The maximum amount of the SDHI per return is limited to $15,000 (for 2009). Thus, for example, if a husband and wife who file a joint return have two children and each spouse has qualifying health coverage that covers that spouse and one child, the maximum SDHI for the joint return is $15,000 for income taxes and $15,000 for payroll taxes.

The SDHI with respect to income taxes would be claimed on the tax return. Employers who provide health insurance that qualifies for the SDHI would apply the SDHI for payroll tax purposes by excluding a pro rata portion of the applicable deduction from the employee's wages for the employee portion of employment tax purposes prior to 2013 and for both the employee and employer portion after 2012. For years before 2013, the employee is entitled to a refund on the tax return of the employer portion of employment taxes paid on the SDHI. In addition, the proposal contemplates that if an employee who purchases his or her own qualifying coverage provides the employer with appropriate proof of coverage, the employer will adjust employment taxes in a similar manner. Insurers would be required to provide individuals with a certificate of coverage. In the event the employee's share of employment taxes are over or underpaid as a result of the SDHI, the difference will be reconciled on the individual's tax return. The method contemplated for reconciling the employer's portion in such cases is unclear. In the case of self-employed individuals, the SDHI applies for both income and self-employment tax purposes.

Effect on other provisions

Under the proposal, the income and employment tax exclusions for employer-provided health coverage, including retiree health coverage, are repealed, except that the exclusions would continue to apply with respect to contributions to an HSA. For example, under the proposal, reimbursements for medical expenses under an FSA or HRA are not excludable from income or wages. The present-law rules for HSAs are not modified by the proposal. Employers are required to include the value of employer provided health coverage in wages on an employee's W-2, and such amounts are subject to withholding and employment taxes. The value of coverage for this purpose is generally determined as under the COBRA continuing health care rules. The employer remains entitled to a deduction for employer-provided health coverage as an ordinary and necessary business expense.

The deduction for health insurance expenses of self-employed individuals under section 162(l) is repealed.

The itemized deduction for expenses in excess of 7.5 percent of adjusted gross income is only available with respect to individuals enrolled in Medicare (generally individuals age 65 or older). For taxable years beginning on or after January 1, 2014, the itemized deduction is available for individuals not otherwise eligible for the SDHI.

The phase-out rate for the EIC for taxpayers with qualifying children is reduced to 15 percent.

Effective date

The proposal is effective for taxable years after December 31, 2008.

Analysis

Issues raised under present law

The present-law Federal tax treatment of health expenses has been the subject of discussion over time from a variety of perspectives, including as part of debates relating to health care reform and tax reform. The exclusion for employer-provided health care is typically a focal point of such discussions. The exclusion represents a departure from the normal income tax principle that compensation should be included in income, and has consistently been one of the three largest tax expenditure items.[93] The enactment of the tax favorable rules for HSAs has also been the subject of debate from both health and tax policy perspectives.

The present-law favorable tax treatment of employer-provided health coverage has generally been justified on the grounds that it encourages employees to prefer health coverage over taxable compensation, thereby increasing health insurance coverage and reducing the number of uninsured. Employees in employer-provided health plans not only receive a tax subsidy, but the employer market also provides a pooling mechanism which may make coverage more affordable. From this perspective, the exclusion may be said to be effective. For 2005, approximately 90 million policyholders are estimated to have employer-provided health coverage.[94]

Nevertheless, the present-law rules have been the subject of a number of criticisms. One criticism is that the present-law rules are inequitable because they do not provide a consistent tax benefit for health coverage. Some argue that this inequity provides the worst treatment in some cases for those who need the tax benefit the most, because many individuals who face the highest insurance rates also receive no tax subsidy for the purchase of such insurance (i.e., individuals

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[93] For Federal fiscal years 2007-2011, the tax expenditure for the exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums is estimated to be $628.5 billion. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07), September 24, 2007.

[94] The number of those insured through the employer market is higher, as many policies cover more than one individual, e.g., the policyholder and his or her family.

who are not self employed and who do not receive coverage through their employer, but purchase insurance in the individual market, receive no tax subsidy unless their health expenses exceed 7.5 percent of adjusted gross income). Some argue that this inequity combined with the lack of group rates in the individual market may lead to some persons remaining uninsured.

The most favorable tax treatment under present law generally is provided to individuals who are in an employer plan.[95] Such individuals may exclude from income and wages employer-provided health insurance and, depending on the employer's plan, may also exclude from income amounts expended for medical care not covered by insurance. Self-employed individuals receive the next most favorable treatment, and may deduct 100 percent of the cost of their health insurance. Individuals who are not self employed and pay for their own health insurance receive the least favorable tax treatment; such individuals may deduct the cost of health insurance only to the extent that aggregate medical expenses exceed 7.5 percent of adjusted gross income and only if they itemize deductions. In the case of individuals covered by a high deductible health plan, the relatively recently-enacted provisions relating to HSAs alter this comparison to some extent; however, those with employer coverage still have the highest potential tax benefit.[96] Table 2, below, shows an example of the various tax treatments of medical expenses for an individual depending on the individual's circumstances. Table 3, below, shows an example of the various tax treatments of medical expenses for an individual with an HSA.

The present-law tax benefits for health coverage have been criticized as contributing to higher health care costs because individuals are not faced with the full cost of health care. That is, the cost of insurance or out-of-pocket expenses paid by the individual is reduced by the tax benefit received, effectively reducing the price of health care relative to other goods.[97] In

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[95] The refundable HCTC provides a greater tax benefit than the exclusion. However, the credit is available to only limited classes of taxpayers. Less than one-half million taxpayers per year are estimated to be eligible for the credit.

[96] With an HSA, both self-employed individuals and those with employer-provided coverage receive a tax benefit for the purchase of the health insurance as well as a tax benefit for out-of-pocket expenses (through the HSA). However, in some circumstances, an employee could, in addition, have an FSA or HRA that provides coverage for additional expenses on a tax-free basis. Thus, for example, an employer plan could provide that the cost of a high deductible plan is paid by the employer and could also allow an FSA that provides certain limited coverage, e.g., for dental or vision benefits. The individual could also have an FSA or HRA in certain other situations, such as an FSA or HRA that pays expenses in excess of the deductible under the high deductible plan. In such cases, the individual could also have an HSA to which deductible contributions could be made. A self-employed individual, in contrast, would not have the opportunity to have an FSA or HRA. Individuals (other than self-employed individuals) who purchase a high deductible plan may make deductible contributions to an HSA, but would not receive a subsidy for the purchase of the insurance unless aggregate medical expenses exceed the adjusted gross income threshold. There is not always a clear distinction between out-of-pocket expenses and expenses covered by insurance, because insurance policies differ. That is, some insurance policies will cover expenses that are out-of-pocket expenses under other policies.

[97] Specifically, because of the income tax exclusion, a dollar of consumption of tax-favored health care actually costs the taxpayer only $(1-t), where t is the tax rate of the individual. In other words,

addition, some argue that the unlimited exclusion for employer-provided coverage leads to very generous insurance coverage, which further contributes to increases in health costs because individuals are not as likely to question medical treatments to the extent the cost is paid by a third party through insurance.

It is also argued that employer-based health coverage may contribute to "job lock" because individuals may be concerned that their health coverage will change if they change employers. The present-law rules relating to continuation coverage, pre-existing conditions limitations and certain other provisions are intended to lessen "job lock" effects.

HSAs provide a subsidy specifically for high deductible health insurance. Proponents of HSAs believe that the use of high deductible plans promotes responsible health policy by making individuals more conscious of their health care costs because fewer expenses are paid by a third party insurer. This, in turn, is anticipated to reduce overall health care costs. Some proponents of HSAs believe that many current health insurance policies cover routine medical expenses and that the tax laws should provide a subsidy only for insurance for unpredictable medical expenses.

Those who do not favor providing additional tax benefits for high deductible plans are concerned that such plans are likely to be more attractive to healthier individuals, with the result that adverse selection will occur which will erode the group market and result in higher insurance costs for individuals with greater health risks. This may occur because when insurance is priced on a group basis, individuals with lower health risks in effect subsidize higher risk individuals. Tax-favored high deductible plans are likely to be more attractive to lower risk individuals. If they leave the pool, however, the average cost increases for those remaining. This, in turn, may cause more lower risk individuals to leave the pool, with a concomitant rise in cost for those remaining. Some argue that this effect is likely to occur with a subsidy for high deductible plans.

There is also disagreement regarding the effects of high deductible plans (and HSAs) on health care costs. As noted above, a basic premise underlying high deductible plans is that individuals will make wiser choices if faced with the cost of medical treatments and that this will reduce health care costs overall. On the other hand, some note that the existence of the HSA itself may undermine the goal of making individuals more conscious of heath care costs because it provides a subsidy for the first dollar of medical expenses. Thus, medical expenses not covered by the high deductible plan receive a tax subsidy, even though they are not covered by insurance. Others are concerned that even if individuals do spend less on health costs with a high deductible plan, this may not necessarily result in better health outcomes or a long-term reduction in costs. For example, it is noted that it may be very difficult for an individual to determine whether a particular medical procedure is in fact needed, and that some individuals will forgo needed care if it is not covered by insurance, with the possibility that longer-term medical costs increase.

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the taxpayer is able to convert $(1-t) dollars of after-tax income into $1 of health consumption. The last column of Tables 2 and 3 reports the value of the tax subsidy as a percentage of the total health costs.

To the extent that amounts in HSAs are not used for current medical expenses, HSAs provide a tax benefit similar to that of an IRA. HSA proponents argue that this feature may help contribute to lowering medical costs by in effect rewarding lower spending on medical care. Others argue that this feature operates to make HSAs primarily attractive to higher income individuals who can afford to self insure for the higher deductible under the high deductible plan and who are primarily interested in a tax-favored savings vehicle.

Some argue that the present-law tax treatment of health coverage is inappropriate because it is not neutral. That is, the present-law rules create distinctions in both the way the coverage is purchased (e.g., through an employer or the individual market) and the type of insurance (e.g., high deductible policies or another type of policy).

Discussions regarding inequities of the present-law rules typically do not include the itemized deduction for medical expenses that exceed 7.5 percent of adjusted gross income. This is because that deduction is generally viewed as having a different policy rationale than the other provisions relating to health care. While the other provisions are generally intended to provide subsidies in various ways for the purchase of health care, the policy behind the itemized deduction for medical expenses is that such expenses generally are not discretionary and that high levels of such expenses adversely impact the individual's ability to pay taxes.

Issues relating to repeal of the exclusion for employer-provided health care

An issue frequently raised with respect to proposals to repeal the exclusion for employer-provided health care is the potential impact on the group market.

Any proposal that seeks to cap or eliminate the exclusion for employer-provided health benefits must include a method of valuing such benefits. Under present law, the premium faced by individuals with employer-provided health coverage may vary based on the health plan and the type of coverage (e.g., self-only or family coverage) but may not vary based on age or health status. Thus, for example, if an employer pays for 80 percent of the cost of coverage under a health plan, a single employee age 25 with no adverse health history will pay the same amount for the coverage as an employee age 55 with high blood pressure and diabetes. By comparison, in the individual health market, these individuals would likely face very different premiums.

The proposal values employer-provided health coverage consistent with present law; that is, the cost of any particular health care plan generally is determined by dividing the total cost equally among all employees covered, with variations based on type of coverage (e.g., self-only vs. family coverage). Most employers are already familiar with this type of approach, as it is essentially that used for purposes of determining permissible premiums under the health care continuation rules.[98]

[98] Employers with 20 or more employees are subject to the COBRA health care continuation rules. While the statute provides the basic rule for determining premiums, many issues are left up to yet-to-be issued regulations. In the absence of regulations, a good faith interpretation of the statutory rules may result in inconsistent methods among employers. If such a result is not considered desirable under proposals to limit the exclusion for employer-provided health care, then additional statutory specification may be needed.

Table 2.–Comparison of Value of Health Tax Benefits: Non-High-Deductible Health Plan

Assume that husband (H) has a health insurance plan that provides coverage for his wife (W) and dependents. The policy's premium is $850 per month ($10,200 annually) and has a $700 deductible. The family's out-of-pocket expenses are approximately $1,400 for the year. Thus, H's annual medical costs are $11,600. H and W file a joint income tax return and their annual adjusted gross income is $70,000.

Situation	Tax-Subsidized Employer Premiums	Tax-Subsidized Employee Premiums	Tax-Subsidized Out-of-Pocket Expenses	Value of Employment Tax[1] (E) and Income Tax[2] (I) Subsidy	Value of Total Tax Subsidy as a Percentage of Total Health Costs
(a) H's health insurance is provided through his employer. The employer pays 75 percent of the premium for such coverage.	$7,650	$0	$0	$1,086 (E) $1,760 (I) $2,846 total	25%
(b) The employer also allows the employee's share of the annual premium to be paid on a tax-free basis (i.e., through a cafeteria plan).	$7,650	$2,550	$0	$1,448 (E) $2,346 (I) $3,794 total	33%
(c) The employer also offers a reimbursement account (i.e., either a health flexible spending arrangement or a health reimbursement arrangement).	$7,650	$2,550	$1,400	$1,647 (E) $2,668 (I) $4,315 total	37%
(d) H is self-employed.[3]	NA	$10,200	$0	$0 (E) $2,346 (I)	20%
(e) H does not have employer-provided coverage and is not self-employed.[3]	NA	Taken into account in determining itemized deduction of $6,350[4]	Taken into account in determining itemized deduction of $6,350[4]	$0 (E) $1,461 (I)	13%

[1] The employment tax subsidy includes both the employer and employee portions of old-age, survivors, and disability insurance ("OASDI") and hospital insurance ("HI"). The effective employment tax subsidy rate is the combined employer and employee tax rate divided by gross-of-tax compensation. The effective subsidy is thus 0.153 *(1 + .0765) = 14.2%

[2] This example assumes an effective income tax rate of 23 percent.

[3] This example ignores the fact that this policy in an individual market would either be more expensive or provide less comprehensive coverage.

[4] Medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income ($70,000 X 7.5% = $5,250. $11,600 - $5,250 = $6,350). For alternative minimum tax purposes, medical expenses are deductible to the extent they exceed 10 percent of adjusted gross income.

Table 3.–Comparison of Value of Health Tax Benefits: High-Deductible Health Plan

Assume that H has a high-deductible health insurance plan that provides coverage for his wife (W) and dependents. The policy's premium is $765 per month ($9,180 annually) and has a $2,000 deductible. H makes contributions of $2,000 to a health savings account ("HSA"). The family's out-of-pocket expenses are approximately $2,420 for the year. Thus, H's annual medical costs are $11,600. H and W file a joint income tax return and their annual adjusted gross income is $70,000.

Situation	Tax-Subsidized Employer Premiums	Tax-Subsidized Employee Premiums	Tax-Subsidized Out-of-Pocket Expenses	Tax-Deductible HSA Contribution[1]	Value of Employment Tax[2] (E) and Income Tax[3] (I) Subsidy	Value of Total Tax Subsidy as a Percentage of Total Health Costs
(a) H's health insurance is provided through his employer. The employer pays 75 percent of the premium for such coverage.	$6,885	$0	$0	$2,000	$ 978 (E) $2,044 (I) $3,022 total	26%
(b) The employer also allows the employee's share of the annual premium to be paid on a tax-free basis (i.e., through a cafeteria plan).	$6,885	$2,295	$0	$2,000	$1,304 (E) $2,571 (I) $3,875 total	33%
(c) The employer also offers a reimbursement account (i.e., either a health flexible spending arrangement or a health reimbursement arrangement).	$6,885	$2,295	$2,420[4]	$2,000	$1,647 (E) $3,128 (I) $4,775 total	41%
(d) H is self-employed.[5]	NA	$9,180	$0	$2,000	$0 (E) $2,571 (I)	22%
(e) H does not have employer-provided coverage and is not self-employed.[5]	NA	Taken into account in determining itemized deduction of $6,350[6]	Taken into account in determining itemized deduction of $6,350[6]	$2,000	$0 (E) $1,921 (I)	17%

[1] Amounts contributed to a HSA can be used to pay qualified out-of-pocket expenses on a tax-free basis.

[2] The employment tax subsidy includes both the employer and employee portions of old-age, survivors, and disability insurance ("OASDI") and hospital insurance ("HI"). This example assumes that HSA contributions are made by the taxpayer. HSA contributions made by the employer would also be excluded from wages for employment tax purposes. See footnote 1 to Table 2 for calculation of employment tax subsidy.

[3] This example assumes an effective income tax rate of 23 percent.

[4] Individuals eligible to make contributions to an HSA must have a high deductible health plan and no other health plan, other than certain permitted coverage. The reimbursement account is permitted if it allows reimbursements only for certain limited purposes (e.g., vision or dental) or in certain other limited situations.

[5] This example ignores the fact that this policy in an individual market would either be more expensive or provide less comprehensive coverage.

[6] Medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income ($70,000 X 7.5% = $5,250. $11,600 - $5,250 = $6,350). For alternative minimum tax purposes, medical expenses are deductible to the extent they exceed 10 percent of adjusted gross income. Distributions from an HSA are not taken into account in determining the itemized deduction. If H used distributions of $2,000 from his HSA to pay qualified medical expenses, the itemized deduction would be limited to $4,350.

While this approach may appear to avoid issues of discrimination based on age or health status, it may have the potential to erode the group market through adverse selection with the result that individuals with higher expected health costs (e.g., a 55-year old with diabetes) pay more for health insurance. If the cost of health insurance were imputed uniformly without regard to health risk, higher risk individuals in the pool would benefit, because their premium would be less than their expected costs (which are higher than average).[99] Lower-risk individuals would be disadvantaged because their premiums would be higher than their expected costs (which are lower than average). In effect, the lower risk individuals would be subsidizing the higher risk individuals. If individuals were allowed to choose whether or not to purchase the group insurance, lower risk individuals might decide that it is better to forgo insurance at such a high price (relative to the value they place on it) or, instead, to purchase insurance with a lower premium in the individual market. When lower risk individuals leave the pool, however, the average cost of insurance increases for those remaining. As prices increase, more lower risk individuals will have an incentive to leave the pool. This process of attrition, known as adverse selection, could continue until only the very high risk individuals are left in the insurance pool. Of course, not all low risk individuals will necessarily leave the pool. Those with high incomes or less willingness to bear risk may be willing to pay a higher price for greater coverage. In addition, the extent of adverse selection may vary depending on any particular proposal. For example, a relatively high cap on the exclusion for employer-provided health care would likely produce less of an adverse selection effect than a lower cap. Some argue that any proposal that has the effect of shifting the purchase of insurance more toward the individual market should include market reforms that would help to counterbalance effects of adverse selection and incorporate some of the consumer protections currently provided in the group market.

Those who support reducing reliance on the current employer-based system argue that such a reduction could have some positive effects. For example, the current reliance on employer-based coverage is sometimes cited as contributing to a "job lock" effect in that employees may stay at their current place of employment because of fear of an undesirable change in health care coverage. It is also argued that, even if employer groups are eroded, other group markets may arise, such as risk pools and purchasing cooperatives. The extent to which such cooperatives would result in true risk sharing and group rating that does not reflect health status would depend on a number of factors, including the regulatory environment in which they are established. It is also argued that, even if the tax subsidy for employer-provided health care were no longer available, employers could give employees the opportunity to purchase group coverage, thereby making group rates available.

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[99] A main argument against pricing goods without regard to risk is that individuals with expensive tastes would receive subsidies from those with more modest needs or tastes. In the context of health services, this argument would take the form that individuals with low health needs should not be required to subsidize those with greater health needs. This argument is most frequently made with respect to health risks that are viewed as life-style choices, such as smoking, drinking, or eating habits. When health risks are looked at over an individual's lifetime, there is less of a difference between individuals with respect to health risk status.

Some believe that to combat group market erosion, any proposal repealing the exclusion for employer-provided health care should include a mechanism to ensure broad risk pooling. They believe that this will reduce the differences in premium costs among individuals with different health histories and increase the availability of affordable insurance for less healthy individuals. Alternatives for achieving varying degrees of risk pooling range from mandating universal coverage at one extreme to requiring guaranteed issue insurance with the imposition of community rating requirements for broad pools of insured individuals.

A number of valuation issues may arise in implementing the repeal of the exclusion for employer-provided health care. For example, many employers have an on-site nurse or first aid facility, free health screenings, or programs relating to weight loss or smoking cessation. It is argued that such services typically are of minimal value and also may be difficult to value, e.g., issues arise as to whether value should be attributed to all eligible employees or only those that use the programs. If such benefits are includible in income and wages, special valuation rules may need to be adopted. Also, employers may decide to discontinue the services if administrative costs of valuation are too high or if employees no longer value the service when it is includible in gross income.

The elimination of the exclusion for employer-provided health benefits will increase the measured wage income for purposes of determining the EIC. In most cases, this will reduce the EIC for the taxpayer, as most EIC recipients have incomes in the phaseout range, and even more would have incomes in the phaseout range upon the removal of the exclusion for employer provided health care. The decrease in the phaseout rate will provide some relief to those whose earned income credit is reduced as a result of the elimination of the exclusion. For those EIC recipients who currently do not have employer provided health, the reduction in the phaseout rate will increase the amount of the EIC that they receive as compared to present law, provided they are in the phaseout range.

Under the proposal, because the SDHI is permitted to reduce earned income for purposes of the EIC, the SDHI could largely offset, or even more than offset, any increase in earned income that would result from the elimination of the exclusion for employer-provided health benefits. In the case of an EIC recipient who receives no employer provided health but purchases qualifying health insurance on his own, the effect of reducing earned income by the amount of the SDHI would depend on their level of earned income. A taxpayer not in the phaseout range of the credit would see their EIC decline, as would many taxpayers in the initial stages of the phaseout of the credit. Taxpayers in later stages of the phaseout would see their EIC rise, and others currently phased out of the credit would become newly eligible.

Setting aside the EIC impacts resulting from the elimination of the exclusion for employer-provided health benefits and the treatment of the SDHI for EIC purposes, the reduction in the phaseout rates for families with qualifying children to 15 percent will increase the length of the phaseout range and thus the amount of the EIC for taxpayers currently in the phaseout range, and will provide a small EIC to those with incomes just beyond the current phaseout range. The length of the phaseout range would increase from $18,255 to $19,447 (or $1,192) for families with one qualifying child, and would increase from $22,906 to $32,160 (or $9,254) for families with two or more qualifying children. The maximum dollar increase in the EIC as a result of the decreased phaseout rate alone would occur at the income level under present law at

which the taxpayer's EIC is completely phased out. This maximum increase in the EIC would be $179 for families with one qualifying child, and $1,388 for families with 2 or more qualifying children.

Standard deduction for health insurance

By reducing Federal income and FICA taxes, the SDHI provides a tax incentive for most taxpayers to purchase health insurance (or encourage employers to purchase it on their behalf as part of compensation) that at least meets the minimum requirements necessary to claim the SDHI. Unlike the current exclusion for employer provided health insurance, the SDHI provides no incentives for the purchase of additional health insurance beyond the level that is necessary to qualify for the SDHI; that is, it does not subsidize what some view as the "gold-plating" of health insurance plans. When coupled with the removal of the exclusion for employer-provided health insurance, the proposed structure for subsidizing the purchase of health insurance will eliminate the inequity of subsidizing employer-provided health insurance but not insurance purchased by individuals (other than the self employed) in the non-group market. Additionally, it will eliminate the unlimited subsidy for health expenses when provided through an employer. Employers would retain the advantage of lower administrative costs for insurance. This advantage would be greatest for large employers and minimal for very small employers.

Under the proposal, a subsidy for the purchase of high deductible health plans would continue to exist, since the employer contributions to accompanying health savings accounts would continue to be excludable for both income and payroll tax purposes, and individuals would continue be able to deduct their contributions for income tax purposes. Additionally, earnings in the accounts would continue to be free from income taxes and the earnings portion of distributions would be excludable from income if spent on qualifying health expenses. Also, a tax code bias favoring employer contributions to HSAs relative to individual contributions to HSAs would continue to exist because the employer contribution is excludable from both income and payroll taxes while individual contributions are deductible only for income tax purposes.

As with the present law exclusion for employer-provided health care, the financial incentive that the SDHI provides will vary with the combined marginal tax rate of the taxpayer from Federal income and FICA taxes. For example, a taxpayer in the 33 percent marginal Federal income tax bracket who claims the $15,000 SDHI will generally reduce his taxes by 33 percent of $15,000, or $4,950 (for simplicity, these examples focus only on the Federal income tax and not FICA taxes). In contrast, a taxpayer in the 15 percent marginal rate bracket would obtain a benefit of 15 percent of $15,000, or $2,250.[100] Taxpayers without taxable income would not benefit in any way from the Federal income tax deduction, and those currently with taxable income less than the deduction would not benefit from the full amount of the deduction.

[100] It is possible that the deduction will cause the marginal tax bracket of the taxpayer to change. For example, a taxpayer with taxable income $10,000 above the beginning of the 15-percent rate bracket would fall into the 10-percent marginal rate bracket after the $15,000 deduction. For such taxpayer, the $15,000 deduction represents income of which $10,000 would otherwise have been taxed at a 15-percent rate, and $5,000 of which would otherwise have been taxed at a 10 percent rate. For such taxpayer the value of the deduction is 15 percent of $10,000, plus 10 percent of $5,000, for a total value of $2,000.

All taxpayers with earnings subject to FICA taxes would benefit from the SDHI exclusion from FICA. In the case of a taxpayer with earnings below the OASDI contribution base ($102,000 in 2008), the value of the $15,000 deduction is $2,295 (15.3 percent of $15,000, reflecting the combined employer and employee FICA tax rates).[101] Prior to 2013, the employee portion of FICA is reduced by the SDHI and the employee is entitled to a refund of the employer portion of FICA on the employee's tax return. After 2012, the SDHI is taken into account for both the employee and employer portions on FICA taxes. In the case of a taxpayer with earnings over the contributions base, the benefit of the exclusion would generally be limited to the combined tax rate from only the HI portion of FICA taxes, or $435 (2.9 percent of $15,000).[102]

Additionally, taxpayers with nonrefundable credits and small tax liabilities after credits might receive a limited Federal income tax benefit from the SDHI as the ability to claim the nonrefundable credits might be restricted after the SDHI is claimed. For example, in 2008, a married couple filing a joint return and reporting $20,000 of taxable income would have a regular tax liability of $2,198. If they were able to claim $2,000 in education credits their net Federal income liability would be $198. If they now were able to claim the $15,000 SDHI, their taxable income would fall to $5,000, resulting in a regular tax liability of $500. The $2,000 in education credits could now only be claimed up to the regular tax liability of $500, resulting in $1,500 of unused education credits since the education credits are not refundable. Thus, while this couple was able to reduce their taxable income by the full amount of the SDHI, the interaction with the nonrefundable personal credits meant that their net tax liability was reduced only $198, from $198 to zero.

Some have criticized the SDHI because the tax benefit provided rises with the marginal tax rate of the taxpayer, and hence in general rises with the income of the taxpayer. Such critics have suggested that, in lieu of the SDHI, a refundable tax credit would be a better approach because all taxpayers would receive the same benefit for the purchase of health insurance. The President's proposal explicitly recognizes that the current tax preference could be replaced with a refundable flat credit. Defenders of the proposed approach note that the deduction approach is a more direct offset to the proposed elimination of the income exclusion for employer-provided health insurance. Additionally, they note that the two provisions are designed to approximately maintain the same tax liability for any taxpayer with an average employer provided plan. Proponents also note that the basic structure of the current Federal income tax provides certain deductions from gross income, such as the standard deduction and the personal and dependent exemptions, which are designed to obtain a measure of taxable income that better reflects ability to pay tax. To such proponents, an adjustment to gross income conditioned on the purchase of health insurance is similar to these other exemptions and therefore is an appropriate adjustment

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[101] Analysts generally believe that employees bear the burden of the employer's share of FICA taxes, and thus the long run benefit of the SDHI with respect to employer paid FICA would similarly accrue to the employee.

[102] Taxpayers with income only somewhat above the OASDI contribution base ($102,000 in 2008) would benefit only from the HI exclusion with respect to that portion of the SDHI equaling the amount of earnings over the contribution base, and would benefit from both the OASDI and HI exclusions with respect to the remaining amount of the SDHI.

to gross income prior to the application of a progressive rate structure. To the extent that upper income taxpayers purchase more insurance with above average cost, the elimination of the exclusion coupled with the provision of the SDHI would increase the progressivity of the tax system. Regardless of the appropriate treatment of health insurance expenses in the tax system, it is nonetheless the case that the proposed SDHI offers little financial incentive for the purchase of health insurance for many low-income taxpayers, who are the least likely to have insurance currently.

One of the objectives of the proposal is to increase the number of insured individuals, and the proposal is likely to have this effect. However, as noted above, the proposal also provides an incentive for individuals to purchase insurance that just meets the minimum requirements for the SDHI. Depending on what the minimum standards are, it is possible that some will purchase minimum coverage primarily for the tax benefits, without purchasing meaningful health insurance.

Some argue that the proposal will have an adverse impact on individuals with substantial medical expenses that are not reimbursed by insurance because of the repeal of the itemized deduction for medical expenses in excess of 7.5 percent of adjusted gross income. The proposal allows the itemized deduction beginning on January 1, 2014, for individuals not eligible for the standard deduction.

The proposal is likely to increase complexity compared to present law. While the present-law regime may raise a variety of issues, in many cases, it is relatively simple to apply. In particular, the exclusion for employer-provided health coverage is simple for both employers and employees because there is no limit on the exclusion and, in many cases, few requirements to be met for the exclusion to apply. In general, no reporting with respect to employer-provided coverage is required. Additional requirements apply in some cases. For example, under HRAs and FSAs, employers need to comply with rules to ensure that expenses submitted for reimbursement qualify for the exclusion.

The proposal creates the need for additional reporting requirements. For example, in order for taxpayers to demonstrate eligibility for the SDHI, the proposal contemplates reporting of coverage by the provider. Employers will also have to determine the value of any employer-provided coverage for purposes of determining the amount includible in income. Over time, to the extent the proposal reduces or eliminates employer provided coverage, this issue may become less significant.

Individuals who are employed but who wish to have the payroll tax reduction from the SDHI applied at the employer level would need to provide information regarding such coverage to employers. The proposal creates the potential for underwithholding or overwithholding in many cases, including situations in which an employee does not provide appropriate proof of insurance coverage to the employer, married couples who are employed by different employers and who both have family coverage, and individuals who are covered by more than one policy. The proposal contemplates that a reconciliation with respect to payroll taxes will be made on the individual's return, at least with respect to the employee portion of payroll taxes. This will impose additional burdens on individuals. Reconciliation of payroll taxes at the employer level after 2012 (to the extent reconciliation is contemplated to occur) will also impose additional

burdens. To the extent retirees are required to include in income the value of employer provided coverage, new issues may arise as to how withholding with respect to such amounts will be implemented.

Prior Action

A substantially similar proposal was included in the President's fiscal year 2008 budget proposal.[103]

2. Expand and make health savings accounts more flexible

Present Law

Health savings accounts

In general

An individual with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish a health savings account ("HSA"). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and wages for employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent. The 10-percent additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions cannot be made to

[103] *See* Joint Committee on Taxation, *Estimating the Revenue Effects of the Administration's Fiscal Year 2008 Proposal Providing a Standard Deduction for Health Insurance: Modeling and Assumptions*, (JCX-17-07), March 20, 2007.

an HSA.[104] An individual who may be claimed as a dependent on another person's tax return may not make contributions to an HSA.

An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary of Treasury may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

A high deductible health plan is a health plan that, for 2008, has a deductible that is at least $1,100 for self-only coverage or $2,200 for family coverage and that has an out-of-pocket expense limit that is no more than $5,600 in the case of self-only coverage and $11,200 in the case of family coverage.[105] Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

Health flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs") are health plans that constitute other coverage under the HSA rules. These arrangements are discussed in more detail below. An individual who is covered by a high deductible health plan and a health FSA or HRA generally is not eligible to make contributions to an HSA. An individual is eligible to make contributions to an HSA if the health FSA or HRA is: (1) a limited purpose health FSA or HRA; (2) a suspended HRA; (3) a post-deductible health FSA or HRA; or (4) a retirement HRA.[106] In addition, as discussed below, an individual is

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[104] Sec. 223(b)(7), as interpreted by Notice 2004-2, 2004-2 I.R.B. 269, corrected by Announcement 2004-67, 2004-36 I.R.B. 459.

[105] The limits are indexed for inflation. The family coverage limits always will be twice the self-only coverage limits (as indexed for inflation). In the case of a plan using a network of providers, the plan does not fail to be a high deductible health plan (if it would otherwise meet the requirements of a high deductible health plan) solely because the out-of-pocket expense limit for services provided outside of the network exceeds the out-of-pocket expense limits.

[106] Rev. Rul. 2004-45, 2004-22 I.R.B. 1. A limited purpose health FSA pays or reimburses benefits for permitted coverage and a limited purpose HRA pays or reimburses benefits for permitted insurance or permitted coverage. A limited purpose health FSA or HRA may also pay or reimburse preventive care benefits. A suspended HRA does not pay medical expenses incurred during a suspension period except for preventive care, permitted insurance and permitted coverage. A post-deductible health FSA or HRA does not pay or reimburse any medical expenses incurred before the minimum annual

eligible to make contributions to an HSA during a health FSA grace period if certain requirements are satisfied.

Tax treatment of and limits on contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. In the case of an employee, contributions to an HSA may be made by both the individual and the individual's employer. All contributions are aggregated for purposes of the maximum annual contribution limit. Contributions to Archer medical savings accounts ("MSAs") reduce the annual contribution limit for HSAs.

The maximum aggregate annual contribution that can be made to an HSA is $2,900 (for 2008) in the case of self-only coverage and $5,800 (for 2008) in the case of family coverage.[107] The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. Individuals who become covered under a high deductible plan in a month other than January are eligible to make the full deductible HSA contribution for the year. An individual who is an eligible individual during the last month of a taxable year is treated as having been an eligible individual during every month during the taxable year for purposes of computing the amount that may be contributed to the HSA for the year. Thus, such individual is allowed to make contributions for months before the individual was enrolled in a high deductible health plan.[108] For the months preceding the last month of the taxable year that the individual is treated as an eligible individual solely by reason of this rule, the individual is treated as having been enrolled in the same high deductible health plan in which the individual was enrolled during the last month of the taxable year.

The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $900 in

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deductible under the HSA rules is satisfied. A retirement HRA pays or reimburses only medical expenses incurred after retirement.

[107] These amounts are indexed for inflation.

[108] If an individual makes contributions under this rule and does not remain an eligible individual during the testing period, the amount of the contributions attributable to months preceding the month in which the individual was an eligible individual which could not have been made but for the rule are includible in gross income. An exception applies if the individual ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the last month of the taxable year and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

2008, and $1,000 in 2009 and thereafter. The additional contribution amounts are also determined on a monthly basis. As previously discussed, contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

If individuals are married to each other and either spouse has family coverage, both spouses are treated as having only the family coverage with the lowest annual deductible. The annual contribution limit (without regard to the catch-up contribution amounts) is divided equally between the spouses unless they agree on a different division (after reduction for amounts paid to any Archer MSA of the spouses).

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. The excise tax generally is equal to six percent of the cumulative amount of excess contributions that are not distributed from the HSA.

Comparable contributions

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period. The comparability rule does not apply to contributions made through a cafeteria plan.

An exception to the comparable contribution requirements allows employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. Highly compensated employees are defined as under section 414(q) and include any employee who was (1) a five-percent owner at any time during the year or the preceding year; or (2) for the preceding year, (A) had compensation from the employer in excess of $105,000[109] (for 2008) and (B) if elected by the employer, was in the group consisting of the top 20 percent of employees when ranked based on compensation. Nonhighly compensated employees are employees not included in the definition of highly compensated employee under section 414(q). The comparable contribution rules continue to apply to the contributions made to nonhighly compensated employees so that the employer must make available comparable contributions on behalf of all nonhighly compensated employees with comparable coverage during the same period.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. In general, amounts in an HSA can be used for qualified medical expenses even if the individual is not currently eligible for contributions to the HSA.

[109] This amount is indexed for inflation.

Qualified medical expenses generally are defined as under section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums other than premiums for Medigap policies. Such qualified health insurance premiums for a beneficiary that has reached Medicare eligibility include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance. Whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred.

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

Reporting requirements

Employer contributions are required to be reported on the employee's Form W-2. Trustees of HSAs may be required to report to the Secretary of the Treasury amounts with respect to contributions, distributions, the return of excess contributions, and other matters as determined appropriate by the Secretary. In addition, the Secretary may require providers of high deductible health plans to make reports to the Secretary and to account beneficiaries as the Secretary determines appropriate.

Health flexible spending arrangements and health reimbursement arrangements

Health FSAs and HRAs are commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents). As previously mentioned, in general, subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is forgone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation.[110] This

[110] Sec. 125(d)(2).

requirement often is referred to as the "use-it-or-lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts available from a health FSA as of the end of a plan year must be forfeited by the employee. In May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.[111] An individual participating in a health FSA that allows reimbursements during a grace period is generally not eligible to make contributions to the HSA until the first month following the end of the grace period.[112] However, for taxable years beginning after December 31, 2006, in certain cases, coverage under a health FSA during the grace period is disregarded coverage for purposes of the HSA rules. Such coverage is disregarded if (1) the balance in the health FSA at the end of the plan year is zero, or (2) in accordance with rules prescribed by the Secretary of Treasury, the entire remaining balance in the health FSA at the end of the plan year is contributed to an HSA. Health FSAs are subject to certain other requirements, including rules that require that the FSA have certain characteristics similar to insurance.

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year.[113] Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA.

Rollovers into HSAs

In general

Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

Limited time rollovers from health FSAs and HRAs into HSAs

Present law allows certain amounts in a health FSA or HRA to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006, or (2) the balance in the health FSA or HRA as of the date of the distribution. Amounts contributed to an HSA are

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[111] Notice 2005-42, 2005-1 C.B. 1204.

[112] Notice 2005-86, 2005-2 C.B. 1075.

[113] Guidance with respect to HRAs, including the interaction of health FSAs and HRAs in the case an individual is covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

excludable from gross income and wages for employment tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible. Contributions must be made directly to the HSA before January 1, 2012. Only one rollover with respect to each health FSA or HRA of the individual is permitted.

If the individual does not remain an eligible individual for a 12-month period, a recapture rule applies.[114] In addition, a modified comparability rule applies.

One-time rollovers from IRAs into HSAs

Present law allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement ("IRA"). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10-percent additional tax on early distributions.

The amount that can be distributed from the IRA and contributed to an HSA is limited to the otherwise maximum deductible HSA contribution amount computed on the basis of the type of coverage under the high deductible health plan at the time of the contribution. The amount that can otherwise be contributed to the HSA for the year of the contribution from the IRA is reduced by the amount contributed from the IRA. No deduction is allowed for the amount contributed from an IRA to an HSA.

Only one rollover from an IRA may be made during the lifetime of the individual.[115] If the individual does not remain an eligible individual for a 12-month period, a recapture rule applies.[116]

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[114] If an individual for whom a contribution is made does not remain an eligible individual during the testing period, the amount of the contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

[115] An exception applies if the rollover is made during a month in which an individual has self-only coverage as of the first day of the month. In that case, an additional rollover may be made during a subsequent month within the taxable year in which the individual has family coverage. The limit applies to the combination of both contributions.

[116] If the individual does not remain an eligible individual during the testing period, the amount of the distribution and contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

Description of Proposal

Expand definition of high deductible health plan to include plans with 50 percent coinsurance

The proposal provides that a health plan qualifies as a high deductible health plan if, in lieu of satisfying the minimum deductible requirements under present law, the plan has a 50 percent or higher coinsurance requirement. In addition, the plan must have a minimum out-of-pocket exposure that, as determined under guidelines established by the Secretary, would result in the same (or lower) premium as coverage under a high deductible health plan for the same family or individual under the present-law requirements.

Include all medical expenses incurred on or after the first day of HSA eligibility as qualified medical expenses

Under the proposal, qualified medical expenses include medical expenses incurred on or after the first day of HSA eligibility for the year as long as the HSA is established no later than the due date for filing the return for that taxable year. Thus, under the proposal, expenses incurred prior to the establishment of the HSA can be paid on a tax-free basis with funds from the HSA.

Allow larger employer contributions for the chronically ill

The proposal provides an exception to the comparable contribution rules for employer contributions on behalf of employees who are chronically ill or employees who have spouses or dependents who are chronically ill. Such contributions are excluded from the comparable contribution requirements.

Allow family coverage to include coverage that includes a lower deductible for each individual

Under the proposal, a plan that, in addition to including an overall deductible that meets the requirements for high deductible family coverage, also includes a separate deductible for each family member qualifies as a high deductible health plan if each individual deductible is at least equal to the minimum deductible for individual high deductible health plan coverage.

Allow both spouses to make additional catch-up contributions to the HSA of one spouse

The proposal provides that if both spouses are eligible individuals, both spouses can contribute the additional catch-up contribution to the HSA of one spouse.

Allow HSA contributions to be made by individuals covered by an FSA or HRA with a reduction in the maximum HSA contribution by the level of FSA or HRA coverage

The proposal allows individuals covered by an FSA or HRA to make contributions to an HSA. Under the proposal, the maximum amount that may be contributed to the HSA is reduced by the level of FSA or HRA coverage.

Effective date

The proposals are effective for taxable years beginning after December 31, 2008.

Analysis

In general

The proposal increases incentives for individuals to purchase high deductible health plans and to contribute to HSAs. The proposal raises both tax and health policy issues. The proposal is intended to enhance the attractiveness of HSAs, thus creating a more market-oriented and consumer driven health care system, with a view toward making health care more affordable and accessible. There is substantial disagreement among analysts as to whether HSAs achieve the stated goals, or have an adverse effect on the affordability, accessibility, and quality of health care coverage.

Issues related to HSAs under present law

The present-law rules for HSAs were designed to provide an incentive to purchase high deductible plans, thereby shifting more routine medical costs from the third-party payor system to the individual. Proponents of HSAs argue that this will cause individuals to be more conscious of health care costs, which will ultimately lower the cost of health care generally. Under present law, HSAs provide, at a minimum, a tax benefit that is equivalent to an above-the-line deduction for medical expenses, up to the annual cap on contributions to the HSA. To the extent that the taxpayer is able to fund the HSA well in advance of the medical expenses, the HSA provides the ability to save for medical expenses on a pre-tax basis. If the funds in the HSA are not used for medical expenses, they may be withdrawn subject to income tax and, prior to age 65, a 10-percent additional income tax. This feature provides a tax benefit similar to that provided under a deductible IRA.

HSA proponents believe that the use of high deductible plans promotes responsible health policy by making individuals more conscious of their health care costs because fewer expenses are paid by a third party insurer. This, in turn, is anticipated to reduce overall health care costs. Some proponents believe that many current health insurance policies cover routine medical expenses and that the tax laws should provide a subsidy only for insurance for unpredictable medical expenses.

Others believe that it is inappropriate to provide a subsidy specifically for high deductible health insurance and HSAs. Those who do not favor providing additional tax benefits for high deductible plans are concerned that such plans are likely to be more attractive to healthier individuals, with the result that adverse selection will occur which will erode the group market and result in higher insurance costs for individuals with greater health risks. This may occur because when insurance is priced on a group basis, individuals with lower health risks in effect subsidize higher risk individuals. Tax-favored high deductible plans are likely to be more attractive to lower risk individuals. If they leave the pool, however, the average cost increases

for those remaining. This, in turn, may cause more lower risk individuals to leave the pool, with a concomitant rise in cost for those remaining.[117]

There is also disagreement regarding the effects of high deductible plans (and HSAs) on health care costs. As noted above, a basic premise underlying high deductible plans is that individuals will make wiser choices if faced with the cost of medical treatments and that this will reduce health care costs overall. On the other hand, some note that the existence of the HSA itself may undermine the goal of making individuals more conscious of heath care costs because it provides a subsidy for the first dollar of medical expenses. Thus, medical expenses not covered by the high deductible plan receive a tax subsidy, even though they are not covered by insurance. Others are concerned that even if individuals do spend less on health costs with a high deductible plan, this may not necessarily result in better health outcomes or a long-term reduction in costs. For example, it is noted that it may be very difficult for an individual to determine whether a particular medical procedure is in fact needed, and that some individuals will forgo needed care if it is not covered by insurance, with the possibility that longer-term medical costs increase.

As noted above, to the extent that amounts in HSAs are not used for current medical expenses, HSAs provide a tax benefit similar to that of an IRA. HSA proponents argue that this feature may help contribute to lowering medical costs by in effect rewarding lower spending on medical care. Others argue that this feature operates to make HSAs primarily attractive to higher income individuals who can afford to self insure for the higher deductible under the high deductible plan and who are primarily interested in a tax-favored savings vehicle.

Issues related to the proposal

In general

In general, the proposals are designed to enhance the attractiveness of high deductible health plans and HSAs and to facilitate the transition into high deductible health plans and HSAs from other plans.

Expand definition of high deductible health plan to include plans with 50 percent coinsurance

Present law requires that to qualify as a high deductible health plan, the plan must have a deductible of at least $1,100 for self-only coverage or $2,200 for family coverage and an out-of-pocket limit of no more than $5,600 for self-only coverage or $11,200 for family coverage (for 2008). The proposal would allow a plan to qualify as a high deductible health plan even if the deductible minimums are not satisfied if the plan has a 50 percent or higher coinsurance

[117] The issue of adverse selection is discussed in greater detail in Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Health Care Expenses* (JCX-12-06), March 6, 2006, tables 2 and 3, at pp. 16-17 and 20-21. See also, Joint Committee on Taxation, *Estimating the Revenue Effects of the Administration's Fiscal Year 2008 Proposal Providing a Standard Deduction for Health Insurance: Modeling and Assumptions*, (JCX-17-07), March 20, 2007.

requirement. The plan must also have a minimum out-of-pocket exposure that, as determined under guidelines established by the Secretary, would result in the same or lower premium as coverage under a present law high deductible health plan for the same individual or family.

Proponents argue that the plan described under the proposal would promote the consumer driven health care goals similar to those advanced by high deductible health plans under present law. Proponents believe that a plan that includes a 50 percent or higher cost sharing component will result in wiser health care decisions which will reduce overall health care costs as individuals will be less likely to make inefficient health care choices when they are required to pay a large portion of the costs.

Others believe that it is inappropriate to provide a subsidy for such policies. They believe that such policies are attractive only to healthier individuals or to higher income individuals who can afford to be responsible for a large portion of their health care costs.

Include all medical expenses incurred on or after the first day of HSA eligibility as qualified medical expenses

Under present law, qualified medical expenses include amounts paid for medical care after an HSA is established. Thus, under present law, expenses incurred before the HSA was established are not qualified medical expenses and cannot be paid from the HSA on a tax-free basis. The proposal would allow expenses incurred before establishment of the HSA to be treated as qualified medical expenses to the extent the expenses were incurred on or after the first day of HSA eligibility for that year. Under the proposal, the HSA must be established no later than the date for filing the tax return for the taxable year (i.e., in most cases, by April 15 of the following year).

Proponents believe that establishing an HSA can take a period of time and that is appropriate to provide preferential tax treatment as long as expenses are incurred once the individual is eligible to establish the HSA. The proposal will allow more time for newly eligible taxpayers to establish HSAs. The proposal can be viewed similar to the present law IRA rules which allow a deduction for a contribution to an IRA as long as the contribution is made by the date for filing the tax return for the taxable year.

Some take the position that before an individual should be eligible to take advantage of the tax preferential treatment afforded to health care expenses paid with amounts from an HSA, the individual should be required to establish an account. They believe that in most cases, establishing an HSA is not a significant burden on the individual. In some cases, the proposal would allow payment of expenses incurred more than a year before establishment of the HSA, which some view as inappropriate.

Allow larger employer contributions for the chronically ill

Under present law, if an employer makes contributions to the HSAs of employees, the employer must make comparable contributions to all individuals with comparable coverage. The proposal would allow higher contributions to be made to the HSAs of chronically ill employees and employees whose spouses or dependents are chronically ill.

Proponents believe that employers should be allowed to make larger HSA contributions to the HSAs of employees who are chronically ill or who have family members who are chronically ill. Individuals who are chronically ill will have higher heath care expenses. With a high deductible plan, this could result in high out-of-pocket costs. Proponents argue that employers should be allowed to make larger contributions for such individuals as their share of health care costs will likely be higher than under a non-high deductible health plan.

Critics argue that allowing larger employer contributions for the chronically ill is an inappropriate response to the issue of higher health care costs of such individuals. They believe that high deductible health plans work to the detriment of the chronically ill and that lower deductible plans offer more advantages especially in the case of such group.

Some argue that nondiscrimination rules should apply so that the employer is prohibited from making larger contributions for certain chronically ill employees (e.g., top executives), but not others. Some believe that if employers make additional contributions for some employees who are chronically ill, comparable additional contributions should be required for all employees who fit within such class.

Definitional issues arise under the proposal. Many believe that it is inappropriate to have a definition of chronically ill which could allow employers to subjectively make the determination as to which employees qualify. Some believe that it is more appropriate for specific guidelines or requirements to be issued by Treasury (or the Department of Health and Human Services) as to what qualifies as chronically ill.

Allow family coverage to include coverage in which each individual can receive benefits once they have reached the minimum deductible for an individual high deductible health plan

In addition to including an overall deductible that meets the requirements for high deductible family coverage, certain plans also include a separate deductible for each family member which is less than the family deductible. Under present law, such a plan would not qualify as a high deductible health plan because, in the case of family coverage, in order to qualify as a high deductible health plan, the plan must have a deductible of at least $2,200 (for 2008). Separate lower deductibles for individuals are not allowed.

Proponents believe that as long as each individual deductible is at least the minimum deductible for individual high deductible health plan coverage, the plan should be considered a high deductible health plan. If each individual within the family had a separate plan with such deductible, each separate plan would qualify as a high deductible health plan. The fact that the individual deductibles are combined with a family deductible should not preclude high deductible health plan treatment. Such plans promote the same objectives as those that meet the definition of high deductible health plan under present law.

Others view the proposal as a weakening of the high deductible health plan requirements since individuals can be afforded benefits before the family deductible is satisfied.

Allow both spouses to make additional catch-up contributions to the HSA of one spouse

Under present law, additional catch-up HSA contributions on behalf of an eligible individual can only be made to the HSA of such individual. The overall contribution limits apply to each HSA account beneficiary.

Proponents believe that the proposal enhances economies of scale. If married individuals choose to make the full family contribution to the HSA of one spouse, they believe that it is appropriate to allow the additional catch-up contribution of both spouses to be made to such account since that is the mechanism used to finance the family's medical expenses.

Others argue that HSAs are individual accounts and it is inappropriate to allow the contribution of one individual to be made to the account of a different individual, even if such individuals are married. Under present law, qualified medical expenses include expenses of the individual's spouse. Thus, under present law, additional catch-up contributions of an individual can be used to pay medical expenses of the individual's spouse.

Allow HSA contributions to be made by individuals covered by an FSA or HRA with a reduction in the maximum HSA contribution by the level of FSA or HRA coverage

Under present law, except in cases of certain limited coverage, individuals covered by an FSA or HRA are not eligible to make contributions to an HSA as coverage under the FSA or HRA constitutes impermissible coverage.

Proponents argue that the proposal would facilitate the transition from non-high deductible health plan coverage to high deductible health plans for those participating in an FSA or HRA. However, the proposal is not limited to cases in which the individual is transitioning from an FSA or HRA to an HSA.

Others argue that the proposal is inappropriate as it allows HSA contributions to be made by individuals who have first dollar coverage, which is inconsistent with the principles behind HSAs.

Prior Action

The proposal was included in the President's fiscal year 2008 budget proposals.

3. Expand human clinical trial expenses qualifying for the orphan drug tax credit

Present Law

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

Description of Proposal

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

Effective date.–The provision is effective for qualified expenditures incurred after December 31, 2007.

Analysis

Approval for human clinical testing and designation as a potential treatment for a rare disease or disorder require separate reviews within the FDA. As a result, in some cases, a taxpayer may be permitted to begin human clinical testing prior to a drug being designated as a potential treatment for a rare disease or disorder. If the taxpayer delays human clinical testing in order to obtain the benefits of the orphan drug tax credit, which currently may be claimed only for expenses incurred after the drug is designated as a potential treatment for a rare disease or disorder, valuable time will have been lost and Congress's original intent in enacting the orphan drug tax credit will have been partially thwarted.

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

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

The staff of the Joint Committee on Taxation recommended a change similar to the current proposal as part of its 2001 simplification study.[118]

Prior Action

An identical proposal was part of the President's fiscal year 2005, 2006, 2007, and 2008 budget proposals. A similar proposal was part of the President's fiscal year 2004 budget proposal.

[118] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(b) of the Internal Revenue Code of 1986, Vol. II* (JCS-3-01), April 2001, p. 310.

D. Provisions Relating to Charitable Giving

1. Permanently extend tax-free withdrawals from individual retirement arrangements for charitable contributions

Present Law

Charitable contributions

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

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[119]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[120]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. Present law provides that no charitable contribution deduction is allowed for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.[121] For a contribution of $250 or more, no charitable deduction is allowed unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[122] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of

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

[120] Sec. 170(a).

[121] Sec. 170(f)(17).

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

an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[123]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base; (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base; and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes an overall limitation on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2008 is $159,950 ($79,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 or 2007, and by two-thirds in taxable years beginning in 2008 or 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[124] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[125] For

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[123] Sec. 6115.

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

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

such interests, a charitable deduction generally is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA.[126] Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA.[127] Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[128] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Traditional IRAs are subject to minimum distribution rules, under which distributions from the IRA must generally begin by April 1 of the calendar year following the year in which the IRA owner attains age 70-½.

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

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[126] Secs. 219 and 408.

[127] Sec. 408A.

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

Withdrawals from IRAs for charitable contributions

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

Effective for distributions made in taxable years beginning after December 31, 2005, gross income excludes otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[129] The exclusion may not exceed $100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been a qualified charitable distribution. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A), other than a supporting organization (as described in section 509(a)(3)) or a donor advised fund (as defined in section 4966(d)(2)). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA to which nondeductible contributions have been made, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the exclusion) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the exclusion) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

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[129] Sec. 408(d)(8). The special exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

Distributions that are excluded from gross income by reason of being qualified charitable distributions are not taken into account in determining the deduction for charitable contributions under section 170.

The special exclusion does not apply to distributions made in taxable years beginning after December 31, 2007.

Description of Proposal

The proposal extends permanently the exclusion from income of qualified distributions made after age 70-½ from a traditional or Roth IRA directly to a qualified charitable organization.

Effective date.–The proposal is effective for distributions made in taxable years beginning after December 31, 2007.[130]

Analysis

Policy issues

In general, the exclusion is intended to enable IRA owners to give a portion of their IRA assets to charity without being subject to the charitable contribution percentage limitations or the overall limitation on itemized deductions. For distributions that are not qualified charitable distributions, present law requires an IRA owner to take the IRA distribution into income, give the money to a qualified charity, and then claim a deduction for the gift. However, the deduction is subject to the percentage limitations of section 170 and to the overall limit on itemized deductions. The exclusion allows an IRA owner to avoid these limitations and therefore may encourage additional charitable giving by increasing the tax benefit of the donation for those who would not be able to fully deduct the donation by reason of the otherwise applicable limitations. However, some argue that the exclusion merely avoids otherwise applicable limitations on charitable contributions that will be made in any event and will not encourage additional giving.

Further, some question the appropriateness of limiting the tax benefits of the exclusion to IRA owners. That is, if the limits on charitable deductions are determined to be undesirable, they should be removed for all taxpayers, not only those who are able to make charitable contributions through an IRA. In addition, the exclusion alters otherwise applicable rules by giving IRA owners a tax benefit for charitable contributions even if they do not itemize deductions. For example, in the case of a distribution that is not a qualified charitable distribution, a taxpayer who takes the standard deduction cannot claim a charitable contribution deduction; however, in the case of a qualified charitable distribution, a taxpayer can both claim the standard deduction and benefit from the exclusion. Therefore, under the proposal, it might be

[130] The President's fiscal year 2009 budget proposal does not specify an effective date, but provides that the present-law exclusion would be made permanent. Therefore, we have assumed for purposes of this description and analysis that the proposal is intended to apply for distributions made in taxable years beginning after December 31, 2007.

beneficial for taxpayers who otherwise would itemize their deductions but have a significant amount of charitable deductions to make their charitable contributions through the IRA and then claim the standard deduction.

In addition, some argue that the exclusion inappropriately encourages IRA owners to use retirement monies for nonretirement purposes (by making such use easier and providing greater tax benefits in some cases). To the extent that the proposal will spur additional gifts by circumventing the percentage limitations, IRA owners may spend more of their retirement money for nonretirement purposes than under otherwise applicable law. Some also argue that an individual might not accurately assess his or her long-term retirement income needs. For example, the individual might not make adequate provision for health care or long-term care costs later in life. Therefore, making a qualified charitable distribution could adversely affect the individual's financial security in retirement.

Other commentators argue that the present-law special exclusion is too restrictive, and that certain present-law requirements should be eliminated if and when the exclusion is extended or made permanent. They argue, for example, that the exclusion would be more effective in encouraging increased charitable giving if: (1) it applied to distributions to supporting organizations, donor advised funds, and private foundations; (2) the $100,000 per taxpayer per taxable year cap were lifted; and (3) the age threshold were lowered from 70-½ to 59-½. Many of these same commentators, however, note that the present-law exclusion already has resulted in significant increases in charitable giving, which calls into question whether expansion of the exclusion by, for example, lowering the age threshold is necessary. In addition, with regard to the $100,000 cap, some note that most taxpayers who have taken advantage of the present-law exclusion have made distributions in an amount between $1,000 and $10,000, which may suggest that lifting the $100,000 cap would benefit relatively few (and primarily wealthy) taxpayers. In addition, some argue that extending the exclusion to distributions to supporting organizations, donor advised funds, and private foundations is not advisable, because money transferred to such organizations may not be timely distributed for a direct charitable purpose.

Prior Action

Proposals to exclude from gross income otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions were included in the President's fiscal years 2004, 2005, 2006, 2007, and 2008 budget proposals. The President's fiscal years 2002 and 2003 budget proposals included a similar proposal, except that the exclusion would have applied to distributions made on or after the date the IRA owner attained age 59-½.

The present-law exclusion for qualified charitable distributions made from a traditional or a Roth IRA in taxable years beginning after December 31, 2005, and beginning on or before December 31, 2007, was enacted as section 1201, Public Law 109-280 (the "Pension Protection Act of 2006").

2. Permanently extend the modified enhanced charitable deduction for contributions of food inventory

Present Law

General rules regarding contributions of food inventory

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[131] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[132] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.[133] Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.[134]

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

[132] Sec. 170(b)(2).

[133] Treas. Reg. sec. 1.170A-4A(c)(3).

[134] *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

Temporary rule expanding and modifying the enhanced deduction for contributions of food inventory

Under a temporary provision enacted as part of the Katrina Emergency Tax Relief Act of 2005 and extended by the Pension Protection Act of 2006, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory.[135] For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.[136]

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as 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 temporary provision does not apply to contributions made after December 31, 2007.

Description of Proposal

The proposal makes permanent the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory.

Effective date.–The proposal is effective for contributions made after December 31, 2007.

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[135] Sec. 170(e)(3)(C).

[136] The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

Analysis

Policy issues

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

In general, the proposal is intended to give businesses, including non C corporations, greater incentive to contribute food to those in need. By extending on a permanent basis the enhanced deduction to businesses other than C corporations, the proposal is intended to encourage more businesses to donate more food to charitable organizations that provide hunger relief. Some argue that if the intended policy is to support food programs for the needy, it would be more efficient to provide a direct government subsidy instead of making a tax expenditure through the tax system, which may result in abuse and cannot be monitored under the annual budgetary process. On the other hand, proponents of the proposal likely would argue that a government program would be less effective in identifying the needy and overseeing delivery of the food than would the proposal.[137]

Prior Action

The President's fiscal year 2003, 2004, 2005, 2006, 2007, and 2008 budget proposals contained a similar proposal, except that the 2003-2007 budget proposals provided for a more generous enhanced deduction for contributions of food inventory and contained special rules for determining a taxpayer's basis in, and the fair market value of, such inventory.

3. Extend deduction for corporate donations of computer technology

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the

[137] *See* generally Louis Alan Talley, "Charitable Contributions of Food Inventory: Proposals for Change Under the 'Community Solutions Act of 2001,'" Congressional Research Service Report for Congress (August 23, 2001).

taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[138]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[139] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expired for any contribution made during any taxable year beginning after December 31, 2007.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed or assembled the property, not later than the date construction or assembling of the property is substantially completed.[140] The original use of the property must be by the donor or the donee,[141] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.[142]

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[138] Sec. 170(e)(1).

[139] Secs. 170(e)(4) and 170(e)(6).

[140] If the taxpayer constructed or assembled the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[141] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[142] Sec. 170(e)(6)(C).

Description of Proposal

The proposal makes the enhanced deduction permanent.

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

Analysis

The enhanced deduction for computer equipment and software is intended to give businesses greater incentive to contribute computer equipment and software to educational organizations and public libraries. In the absence of the enhanced deduction of present law, if a taxpayer were to dispose of excess inventory by dumping unneeded computer equipment in a garbage dumpster, the taxpayer generally could claim the purchase price of the inventory (the taxpayer's basis in the property) as an expense against the taxpayer's gross income. Similarly, if the taxpayer were to donate the unneeded computer equipment to a school or library, the taxpayer generally would be able to claim a charitable deduction equal to the taxpayer's basis in the computer equipment (subject to certain limits on charitable contributions). The taxpayer may therefore be indifferent between donating the computer equipment and dumping the computer equipment in a garbage dumpster. However, if the taxpayer must incur costs to deliver the computer equipment to the school or library, the taxpayer may not find it in the taxpayer's financial interest to donate the computer equipment to the school or library. On the other hand, a taxpayer may make a contribution regardless of any tax benefit because of goodwill generated by the gift. For example, a company may determine that a contribution of computers to public libraries will expose potential new buyers to its products and that such goodwill alone is worth any incremental costs incurred to deliver the equipment.

Proponents argue that present law helps accelerate the nationwide adoption of computer technology in education and helps provide more individuals internet access through their local public library. Proponents argue that the need for technology resources is ongoing, and that it therefore is appropriate to make the present-law enhanced deduction permanent. However, some argue that if the intended policy is to promote adoption of computer technology in education and internet access via public libraries, it would be more efficient to provide a direct government subsidy instead of making a tax expenditure through the tax system, which cannot be monitored under the annual budgetary process.

The proposal, like present law, predicates the enhanced deduction on an ascertainable fair market value of the computer technology.[143] With the rapid advances in the field, such determinations are difficult at times, and computers lose value quickly.[144] To ease

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[143] The enhanced deduction is equal to the lesser of basis plus one-half of the item's appreciation (that is, basis plus one-half of fair market value in excess of basis) or two times basis. The two times basis limitation is binding only if the fair market value of the item exceeds three times the item's basis. Thus, a measure of fair market value always is necessary.

[144] A recent study concludes that "[n]ot surprisingly, our empirical results indicate that PCs lose value at a rapid pace. … [T]he value of a PC declines roughly 50 percent, on average, with each year of use, implying that a newly installed PC can be expected to be nearly worthless after five or six years of

administration and provide greater certainty for taxpayers and the IRS, the enhanced deduction could alternatively be based not on the value of the computer equipment but on the taxpayer's basis in the equipment and the equipment's age. For example, equipment one year old or less could receive a deduction of up to twice the taxpayer's basis; equipment between one and two years old could receive a deduction of a lesser multiple of the taxpayer's basis; and equipment two years old or greater could receive a deduction of an even lesser multiple of the taxpayer's basis.[145] The reduction in the deduction over time could be justified by the generally rapid decrease in value of computer equipment over time. The deduction still would be an enhanced deduction because the taxpayer would receive more than its basis in the property. Under such an alternative, the basis multiple would have to be determined based on information about the markup of new items and the rate of loss of value over time. However, assuming that the relationship between value and basis varies over time, the basis multiple would need to be adjusted regularly.

Prior Action

The President's fiscal year 2004, 2005, and 2006 budgets proposed extending the provision temporarily. The President's fiscal year 2008 budget proposed making the provision permanent.

4. Permanently extend increased limits on contributions of partial interests in real property for conservation purposes

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[146]

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

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service. Mark E. Doms, Wendy E. Dunn, Stephen D. Oliner, and Daniel E. Sichel, "How Fast Do Personal Computers Depreciate? Concepts and New Estimates," in James M. Poterba (ed.), *Tax Policy and the Economy, vol. 18*, (Cambridge, MA: The MIT Press), 2004

[145] As under present law, the deduction could not exceed fair market value.

[146] Secs. 170, 2055, and 2522, respectively.

carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

In general

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet

certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

Temporary increase in limits for qualified conservation contributions

For qualified conservation contributions made in taxable years beginning after December 31, 2005, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50-percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the non-conservation contributions (50 percent of the $100 contribution base) and is allowed to carry over the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified conservation contribution is allowed and $30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable

charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made after December 31, 2005, and on or before August 17, 2006.

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

The increased limitations on the deductibility of qualified conservation contributions do not apply to contributions made in taxable years beginning after December 31, 2007.

Description of Proposal

The proposal makes permanent the increased limits on the deductibility of qualified conservation contributions.

Effective date.–The proposal is effective for contributions made in taxable years beginning after December 31, 2007.

Analysis

The proposal is intended to spur additional charitable giving for conservation purposes by making permanent the temporary provision that provides for enhanced tax benefits to donors who make qualified conservation contributions by (1) increasing the limits on deductions of such contributions and (2) permitting excess contributions to be carried over to more future years than otherwise would be permitted. However, some argue that the benefits of the proposal (and of the temporary provision under present law) are available only to donors of partial interests in property (such as easements) and not to donors who donate an entire parcel of real property for conservation purposes without retaining an interest in such property. Arguably, providing a greater tax benefit to donors who retain an interest in property given to charity than to donors who do not retain an interest will in some cases discourage more significant contributions in favor of more limited ones. Such a result might be seen as inconsistent with the intended purpose of the proposal. On the other hand, one could argue that the proposal will lead to an overall increase in contributions for conservation purposes, which is consistent with the stated policy goal of the proposal.

The proposal provides for even greater tax benefits to qualified farmers and ranchers who make qualified conservation contributions by replacing the otherwise applicable percentage limitations with a 100-percent limitation. If an intended goal of the proposal is to provide financial support to farmers and ranchers, some might argue that it would be more efficient to

provide a direct government subsidy than to provide indirect benefits through the tax system. On the other hand, proponents of the proposal likely would argue that such a government program would be less likely to encourage owners of significant tracts of land to protect the land in perpetuity for conservation purposes.

Prior Action

The President's Fiscal Year 2008 budget proposal included an identical proposal. Public Law 109-280 (the "Pension Protection Act of 2006") enacted the present-law provision that provides for increased limits on the deductibility of qualified conservation contributions for contributions made in taxable years beginning after December 31, 2005, and beginning on or before December 31, 2007.

5. Permanently extend the basis adjustment to stock of S corporations contributing appreciated property

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[147] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[148]

For taxable years beginning before 2008, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution of appreciated property made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[149]

For taxable years beginning after 2007, the basis reduction is equal to the shareholder's full amount of the contribution.

Description of Proposal

The proposal makes permanent the pre-2008 rule reducing stock basis by reference to the basis of the contributed property.

Effective date.–The proposal applies to taxable years beginning after December 31, 2007.

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

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

[149] Also, for taxable years beginning before 2008 (but not thereafter), the basis limitation of section 1366(d) does not apply to shareholder's share of the appreciation in the contributed property.

Analysis

The proposal preserves the benefit of providing a charitable contribution deduction for contributions of property by an S corporation with a fair market value in excess of its adjusted basis by limiting the reduction in the shareholder's basis in S corporation stock to the proportionate share of the adjusted basis of the contributed property.

The following example compares the effect of not extending the proposal with the effect of the proposal extending the rule relating to the basis adjustment:

Example.–Assume that an individual owns all the stock of a calendar-year S corporation. Assume that the individual's basis in the stock on December 31, 2006, is $1,000, and that the fair market value of the stock is also $1,000 so that no gain or loss would be realized on the sale of the stock.

Assume that on January 1, 2007, a shareholder contributes $100 in cash to the corporation. The shareholder's adjusted basis of its stock is thereby increased by $100 to $1,100. On March 1, 2007, the corporation purchases a capital asset for $100. On July 1, 2008, when the fair market value of the asset is $250, the corporation makes a charitable contribution of the asset. Assume this is the only transaction the corporation engages in during the period covered by this example.

Under both present law and the proposal, the shareholder is entitled to a $250 charitable contribution deduction (assuming the percentage limitations of section 170(b) and the reductions under section 170(e) do not apply) for 2008. Under the proposal, the basis of the stock of the S corporation is reduced by $100, the amount of the basis of the property contributed. If the shareholder sold the S corporation stock for $1,000 in 2009, no gain or loss would be recognized. This is the same result that would arise if the shareholder, rather than the S corporation, had instead purchased the capital asset and made the contribution.

Under the law in effect for 2008 without an extension, the basis of the stock of the S corporation is reduced by the $250 amount of the charitable contribution. If the shareholder sold the S corporation stock for $1,000 in 2009, $150 gain would be recognized.

Prior Action

A similar proposal was included in the President's fiscal year 2003, 2004, 2005, 2006, 2007 and 2008 budget proposals.

Public Law 109-280 (the "Pension Protection Act of 2006") enacted the present law provision for taxable years beginning in 2006 and 2007.

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

Present Law

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax

on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts, also are subject to an excise tax, under section 4940(b).

Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[150] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[151] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements.[152]

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code. Exempt operating foundations are exempt from the section 4940 tax.[153]

Nonoperating private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[154]

Description of Proposal

The proposal replaces the two rates of excise tax on private foundations with a single rate of tax and sets the rate at one percent. Thus, under the proposal, a tax-exempt private foundation is subject to tax on one percent of its net investment income. A taxable private foundation is

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[150] Sec. 4942(g).

[151] Sec. 4940(e).

[152] Sec. 4942.

[153] Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

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

subject to tax on the excess of the sum of the one percent excise tax and the amount of the unrelated business income tax (both calculated as if the foundation were tax-exempt) over the income tax imposed on the foundation. The proposal repeals the special one-percent excise tax for private foundations that exceed their historical level of qualifying distributions.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2008.

Analysis

The proposal has the effect of increasing the required minimum charitable payout for private foundations that pay the excise tax under present law at the two-percent rate.[155] This may result in increased charitable distributions for private foundations that pay only the minimum in charitable distributions under present law. For example, if a foundation is subject to the two-percent excise tax on net investment income, the foundation reduces the amount of required charitable distributions by the amount of excise tax paid. Because the proposal decreases the amount of excise tax paid on net investment income for such foundations, the proposal increases such foundations' required minimum amount of charitable distributions by an amount equal to one percent of the foundation's net investment income. Thus, the proposal results in an increase of charitable distributions in the case of foundations paying the two-percent rate and distributing no greater than the required minimum under present law. Foundations paying the two-percent rate that exceed the required minimum under present law generally would not have to increase their charitable distributions as a result of the proposal. Although the required minimum amount of charitable distributions would increase for such foundations, such foundations already make distributions exceeding the minimum and so generally would not have to increase charitable distributions as a result of the proposal (except to the extent that the increase in the required minimum amount was greater than the excess of a private foundation's charitable distributions over the required minimum amount of present law). However, a reduction in the excise tax rate from two percent to one percent may result in increased charitable distributions to the extent that a foundation decides to pay out the amount that otherwise would be paid in tax for charitable purposes.

The proposal also eliminates the present-law two-tier tax structure. Some have suggested that the two-tier excise tax is an incentive for foundations to increase the amounts they distribute to charities.[156] Critics of the present-law two-tier excise tax have criticized the efficiency of the excise tax as an incentive to increase payout rates. First, critics note, the reduction in excise tax depends only upon an increase in the foundation's rate of distributions to charities, not on the size of the increase in the rate of distributions. Thus, a large increase in distributions is rewarded

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

[156] In general, foundations that make only the minimum amount of charitable distributions and seek to minimize total payouts have no incentive to decrease their rate of excise tax because such a decrease would result in an increase in the required minimum amount of charitable distributions, thus making no difference to the total payout of the private foundation.

by the same reduction in excise tax rate as is a small increase in distributions. There is no extra incentive to make a substantial increase in distributions rather than a quite modest increase in distributions.

In addition, critics assert that, under a number of circumstances, the present-law two-tier excise tax can create a disincentive for foundations to increase charitable distributions substantially.[157] In order to take advantage of the one-percent excise tax rate, a private foundation must increase its rate of charitable distributions in the current year above that which prevailed in the preceding five years. Whether the present-law two-tier excise tax creates an incentive or disincentive to increased payout rates depends, in part, on whether the foundation currently is subject to the one-percent tax rate or the two-percent tax rate. Because modest increases in payout rates qualify a foundation for the one-percent tax rate, some analysts suggest that a foundation may be able to manage its distributions actively so that the foundation qualifies for the one-percent tax rate without substantially increasing its payout rate.[158] For a foundation subject to the one-percent rate in the current year, an increased payout in any year becomes part of the computation to determine eligibility for the one-percent rate in future years. Thus, under the present-law formula, the foundation can trigger the two-percent excise tax rate by increasing the payout amount in a particular year because increased payouts make it more difficult for the foundation to qualify for the one-percent rate in subsequent years, and it increases the possibility that the foundation will become subject to the two-percent tax rate. Consequently, over time, the one-percent rate provides a disincentive for increasing charitable distributions.

On the other hand, for a foundation currently subject to the one-percent excise tax rate and also making charitable distributions at a rate above the minimum required amount, the present-law two-tier excise tax can create a disincentive for foundations to reduce their payout rate. A reduction in payout rate in the future would reduce the foundation's five-year moving average, thereby increasing the likelihood the foundation's net investment income is taxed at the two-percent rate, rather than the one-percent rate.[159]

For a foundation currently subject to the excise tax at the two-percent rate, an increase in payout may qualify the foundation for the one-percent excise tax rate. If the increase does qualify the foundation for the one-percent rate, and the foundation maintains the same payout for the subsequent four years, the foundation generally will be eligible for the one-percent tax rate in each of the five years. Hence the reduced tax rate can create an incentive to increase payout

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[157] *See* C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," *American Journal of Tax Policy*, 12, Fall 1995, at 399-447.

[158] For example, if over a 10-year period the foundation increased its payout rate from the minimum 5.00 percent to 5.01 percent, to 5.02 percent, up to 5.10 percent, the foundation generally would qualify for the one-percent excise tax rate throughout the 10-year period.

[159] Whether a reduction in payout rate causes the foundation to pay the two-percent tax rate depends upon the specific pattern of its payout rate in the preceding five years and the magnitude of the decrease in the current year.

rates. However, even in the case of a two-percent excise tax paying foundation, the present-law two-tier excise tax can create a disincentive for a foundation to increase charitable distributions substantially in any one year compared to a strategy of slowly increasing payouts over several years. For example, consider a foundation which has had a payout rate of 5.0 percent for several years. Suppose the foundation is considering increasing its payout rate. Consider two possible strategies: increase the payout rate to 8.0 percent in the current year followed by rates of 5.5 percent thereafter; or gradually increase the payout rate by increments of one-tenth of one percent annually for five years. While a substantial increase in any one year may qualify the foundation for the one-percent tax rate, subsequent year payout rates of 5.5 percent would fail to qualify the foundation for the one-percent tax rate.[160] Thus, under the first option, the foundation would pay the one-percent tax rate for one year and be a two-percent tax rate payor subsequently. Under the second option, the foundation would qualify for the one-percent rate in each year. However, total payouts are greater under the first option.

In summary, the incentive effects of the present-law two-tier excise tax depend upon the situation in which the foundation finds itself in the current year. In 2004, 43.9 percent of foundations were one-percent tax rate payors and 56.1 percent were two-percent rate payors. Among large foundations (assets of $50 million or greater) 50 percent were one-percent rate payors and 50 percent were two-percent rate payors.[161] A number of analysts suggest the optimal tax strategy for a private foundation is to choose a target rate of disbursement, maintain that rate in all years, and never fall below the target in any year.[162]

Critics of the present-law excise tax structure observe that the median payout rate of large nonoperating private foundations (foundations with total assets of $50 million or more) was 5.1 or 5.0 percent in each year from 1991 through 1995 and was 5.0 percent in 1999.[163] However, the payout rate for such foundations increased to 5.5 percent in 2001[164] before falling back to 5.1

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[160] In this example, after having paid out 8.0 percent, the five-year average payout for the first year in which the foundation pays out 5.5 percent would be 5.6 percent.

[161] *See* Figure F in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts: Charitable Distributions and Investment Assets, Tax Year 2004," Internal Revenue Service, *Statistics of Income Bulletin*, 27, Fall 2007 at 181.

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

[163] *See* Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 at 73 and Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002 at 148.

[164] *See* Figure J in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 2001," Internal Revenue Service, *Statistics of Income Bulletin*, 24, Fall 2004 at 153.

percent in 2004.[165] The median payout rates for foundations with assets between $10 million and $50 million declined annually from 5.4 percent in 1990 to 5.1 percent in 1995 and 1999[166] but increased slightly to 5.4 percent in 2003 and 5.2 percent in 2004.[167] Similarly, the median payout rates for foundations with assets between $100,000 and $1 million declined from 6.7 percent in 1990 to 5.5 percent in 1995 and 5.4 percent in 1999[168] but increased to 6.2 percent in 2001.[169]

Finally, some argue that the tax on net investment income of private foundations serves no legitimate policy purpose and thus should be eliminated rather than modified and retained. The tax originally was intended as a fee to fund administration of exempt organizations generally. However, there is no evidence that revenue from the tax affects in any way the amount that is appropriated to the IRS for administration of programs related to exempt organizations. Thus, the original reason for the tax is not present and, arguably, the tax could be eliminated.[170]

Prior Action

The President's fiscal year 2003, 2004, 2005, 2006, 2007, and 2008 budget proposals included a similar proposal.

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[165] *See* Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts: Charitable Distributions and Investment Assets, Tax Year 2004," Internal Revenue Service, *Statistics of Income Bulletin*, 27, Fall 2007 at 186.

[166] *See* Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 at 73 and Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002 at 148.

[167] *See* Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts: Charitable Distributions and Investment Assets, Tax Year 2004," Internal Revenue Service, *Statistics of Income Bulletin*, 27, Fall 2007 at 186.

[168] *See* Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 at 73 and Figure I in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002 at 148.

[169] *See* Figure J in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 2001," Internal Revenue Service, *Statistics of Income Bulletin*, 24, Fall 2004 at 153.

[170] The staff of the Joint Committee on Taxation recommended elimination of the tax in 2001 on the ground that elimination would simplify the tax law and could be justified because the original reason for the tax no longer existed. See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Volume II at 459.

The President's fiscal year 2001 budget proposal included a similar proposal, but would have reduced the rate of tax to 1.25 percent.

E. Provisions Relating to Education

1. Permanently extend the above-the-line deduction for qualified out-of-pocket classroom expenses

Present Law

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

In general, ordinary and necessary business expenses are deductible (sec. 162). However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $159,950 ($79,975 for married individuals filing separate returns) for 2008. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2008, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.[171] To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

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

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2007.

General rules regarding education expenses

An individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a

[171] Sec. 62(a)(2)(D).

skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.[172] Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.

For taxable years beginning before January 1, 2008, an individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during a taxable year that are required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible educational institution of higher education for courses of instruction of such individual at such institution.[173]

Unreimbursed educational expenses incurred by employees

In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous itemized deductions, exceed two percent of the taxpayer's adjusted gross income. Itemized deductions subject to the two-percent floor are not deductible for minimum tax purposes. In addition, present law imposes a reduction on most itemized deductions, including the employee business expense deduction, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2008 is $159,950 ($79,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, EGTRRA phases out the overall limitation on itemized deductions for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009, although this elimination of the limitation sunsets on December 31, 2010.[174]

Contributions to a school may be eligible for a charitable contribution deduction under section 170. A contribution that qualifies both as a business expense and a charitable contribution may be deducted only as one or the other, but not both.

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

[173] Sec. 222. The deduction is not allowed for taxpayers with adjusted gross income in excess of $80,000 ($160,000 in the case of married taxpayers filing a joint return).

[174] A separate proposal contained in the President's fiscal year 2009 budget permanently extends the elimination of the overall limitation on itemized deductions after 2010. See Part I.A of this document for a description of that proposal.

Description of Proposal

The present law provision is made permanent.

Effective date.–The proposal is effective for expenses incurred in taxable years beginning after December 31, 2007.

Analysis

The present-law section 62 above-the-line deduction is intended to make fully deductible many of the legitimate business expenses of eligible schoolteachers. As described below, and absent an above-the-line deduction, the expenses might otherwise be deductible except for the two-percent floor that applies to miscellaneous itemized deductions. Some have observed that the two-percent floor increases pressure to enact above-the-line deductions on an expense-by-expense basis. The expense-by-expense approach is not fair to other taxpayers with legitimate business expenses that remain subject to the two-percent floor.

Extending the present-law above-the-line deduction presents compliance issues. One reason the two-percent floor was introduced was to reduce the administrative burden on the IRS to monitor compliance with small deductions. Some argue that any proposal that circumvents the two-percent floor will encourage cheating. Others argue that although cheating is a risk, the risk is the same for similarly situated taxpayers (e.g., independent contractors or taxpayers with trade or business income) who are not subject to the two-percent floor on similar expenses.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, and 2008 budget proposals.

2. Allow the Saver's credit for contributions to qualified tuition programs (section 529 plans)

Present Law

Saver's credit

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[175] The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2008, married taxpayers filing joint returns with AGI of $53,000 or less, taxpayers filing head of household returns with AGI of $39,750 or less, and all

[175] Sec. 25B(a).

other taxpayers filing returns with AGI of $26,500 or less are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2008 are provided in Table 3, below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

Table 4.–Credit Rates for Saver's Credit

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0 – $32,000	$0 – $24,000	$0 – $16,000	50 percent
$32,001 – $34,500	$24,001 – $25,875	$16,001 – $17,250	20 percent
$34,501 – $53,000	$25,876 – $39,750	$17,251 – $26,500	10 percent
Over $53,000	Over $39,750	Over $26,500	0 percent

The Saver's credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 years old or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b)" annuity), an eligible deferred compensation arrangement of a State or local government (a "section 457 plan"), a savings incentive match plan for employees ("SIMPLE"), or a simplified employee pension ("SEP"); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax-sheltered annuity or qualified retirement plan. Under the rules governing these arrangements, an individual's contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount or the individual's compensation that is includible in income. In the case of IRA contributions of a married couple, the combined includible compensation of both spouses may be taken into account. In addition, for purposes of determining the IRA contribution limit, an individual's includible compensation is determined without regard to the exclusion for combat pay.[176] Thus, excluded combat pay received by an individual is treated as includible compensation for purposes of determining the amount that the individual (and the individual's spouse) can contribute to an IRA.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

[176] Sec. 219(f)(7).

Qualified tuition programs (section 529 plans)

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[177] A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

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

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[177] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner") whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.[178]

Social Security benefits

Social Security benefits are taxed under a two-tier system.[179] Taxpayers receiving Social Security benefits are not required to include any portion of such benefits in gross income if their "provisional income" does not exceed a first-tier threshold, which is $25,000 in the case of unmarried individuals and $32,000 in the case of married individuals filing joint returns.[180] Individuals with provisional income in excess of this threshold but below a second-tier threshold are required to include up to 50 percent of their Social Security benefits in gross income. Individuals with provisional income in excess of the second-tier threshold of $34,000 in the case of unmarried individuals and $44,000 in the case of married individuals filing joint returns are required to include up to 85 percent of their Social Security benefits in gross income.[181]

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[178] Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.

[179] Sec. 86(a).

[180] In the case of a married individual who files a separate return, the first-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the first-tier threshold is $25,000.

[181] In the case of a married individual who files a separate return, the second-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the second-tier threshold is $34,000.

Description of Proposal

The proposal adds contributions to qualified tuition programs to the list of deferrals or contributions that qualify for the Saver's credit. The proposal does not increase the $2,000 per individual annual limit on contributions subject to the Saver's credit.

Under the proposal, the taxpayer's contributions must be to a qualified tuition program account over which the taxpayer has the power to authorize distributions and otherwise administer the account. Solely in the case of qualifying contributions to qualified tuition programs, the credit rate is determined by including in AGI the otherwise excludable portion of a contributing taxpayer's Social Security benefits.

Under the proposal, a taxpayer's aggregate contributions to qualified tuition programs to which the credit applies cannot exceed the taxpayer's compensation that is includible in gross income, if less than $2,000. For married individuals filing a joint return, the aggregate contributions to qualified tuition programs to which the credit applies cannot exceed the lesser of the combined includible compensation of both spouses or $4,000.[182]

Consistent with present-law rules, the proposal adds distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return) from qualified tuition plans within a certain period to the list of distributions that the taxpayer must subtract from the taxpayer's otherwise eligible contribution to determine the net amount of the taxpayer's contribution eligible for the credit.

Effective date.–The proposal is effective for contributions to qualified tuition programs made on or after January 1, 2009.

Analysis

The present-law Saver's credit offers an incentive to lower income individuals to save for retirement by providing a nonrefundable credit equal to a percentage of their qualified contributions (of up to $2,000) to certain retirement plans. The proposal expands the types of savings that taxpayers may make to qualify for the Saver's credit by adding contributions to qualified tuition programs.

Some argue that allowing the Saver's credit for contributions to qualified tuition programs might encourage some taxpayers who are concerned about paying the future college expenses of their children (or certain relatives) to start saving, or to save more than they are currently saving, to meet those expenses. It may also encourage certain taxpayers (such as grandparents) to save, even though they are not currently saving because they believe they do not need to save further for retirement or do not need to save for retirement at the current time. To the extent there is a net increase in the total amount of savings for retirement and for higher

[182] Under the proposal, excluded combat pay received by a taxpayer is treated as includible compensation for purposes of determining the amount of the taxpayer's contributions to qualified tuition programs to which the Saver's credit applies.

education, the expansion of the types of contributions that qualify for the Saver's credit will further the broad goal of the Saver's credit to encourage savings.

Others argue that the proposal's expansion of the types of contributions that qualify for the Saver's credit might reduce retirement savings, which the Saver's credit currently is intended to encourage, by causing taxpayers who might otherwise save for retirement to shift those savings to qualified tuition programs. To the extent taxpayers merely shift their savings in this way, the proposal will not result in any increase in aggregate savings.

For many taxpayers, their or their children's future higher education expenses might appear as a more pressing need than the expenses they will incur in retirement as they will typically face the higher education expenses first. However, by delaying retirement savings for several years, a taxpayer could greatly reduce the amount of total assets that he or she will have available to utilize in retirement. The reason for this reduction is that by delaying the date on which retirement savings starts, the taxpayer is reducing the total period during which he or she may save for retirement (assuming that the individual's desired retirement age does not change). During those years that the taxpayer does not save for retirement, the taxpayer effectively reduces (compared to the case in which the taxpayer is saving for retirement during those years) his or her future retirement assets as a result of the retirement savings that are not being set aside each year and, most importantly, by the forgone opportunity to earn a return on those savings (and on the return) during those years and during all future years during which savings does occur.

Notwithstanding the clear benefits to starting to save for retirement at an early age, higher education expenses represent a real, and oftentimes, substantial cost. There are, however, a variety of programs available from both the public and private sectors that are designed to help students (and their parents) meet those costs, including various loan programs, merit-based assistance programs, and need-based assistance programs. There may be fewer opportunities for individuals to mitigate the costs they incur in retirement if they have failed to adequately save.

Another aspect of the proposal meriting discussion is that the proposal allows contributions to qualified tuition programs to qualify for the Saver's credit, but does not allow any other type of education savings to qualify. Specifically, the proposal does not permit contributions to Coverdell education savings accounts ("Coverdell ESAs") to qualify. By not permitting contributions to Coverdell ESAs to qualify for the Saver's credit, the proposal favors contributions to qualified tuition programs.

Coverdell ESAs have many similarities to qualified tuition programs, including: (1) amounts in the account accumulate on a tax-free basis; (2) distributions from the account may be made on a tax-free basis to pay qualified higher education expenses; and (3) the account beneficiary may be changed.[183] However, there are differences between the two types of education savings plans. Some of the differences between the accounts may make qualified tuition programs more attractive and some may make Coverdell ESAs more attractive. Features

[183] Sec. 530.

of Coverdell ESAs that may make them less attractive than qualified tuition programs are that Coverdell ESAs have lower contribution limits (currently, $2,000 a year per child for Coverdell ESAs and no quantitative limit for qualified tuition programs) and require amounts in the accounts to be distributed by the time the beneficiary is 30 years old (qualified tuition programs have no similar restriction). Features of Coverdell ESAs that may make them more attractive are that there is a wider range of investment opportunities for amounts in the account and tax-free distributions may be made to pay qualified elementary and secondary expenses, in addition to qualified higher education expenses.

On the one hand, the similarities between the two types of education savings plans might suggest that contributions to both types of plans should qualify for the Saver's credit. To the extent the proposal is designed to encourage further savings, or, even more specifically, further education savings, a taxpayer's contribution to either type of plan is consistent with that objective. On the other hand, the differences between the two types of plans might explain the proposal's preference for qualified tuition program contributions. For example, the proposal might reflect a desire to encourage savings for higher education expenses, but not for elementary and secondary expenses. Nevertheless, there does not appear to be a strong tax policy rationale for favoring qualified tuition programs over Coverdell ESAs in this context.

The proposal's treatment of excluded Social Security benefits may be viewed as more accurately targeting the Saver's credit to taxpayers with the lowest economic income, and, as a result, the greatest economic need for a saving's incentive that makes it easier for them to save by reducing their net cost of saving. Under present law, the calculation of the amount of a taxpayer's Saver's credit does not take into account the portion of the taxpayer's Social Security benefits excluded from gross income. Thus, the calculation understates the taxpayer's economic income. Consequently, the calculation potentially allows the taxpayer to qualify for a greater credit than another taxpayer who has lower economic income, but all of which is reflected in the Saver's credit calculation. In practice, this concern does not appear to be a substantial issue under present law as the number of taxpayers who receive Social Security benefits and make retirement plan contributions that qualify for the Saver's credit is a small percentage of the total number of taxpayers that receive the Saver's credit. Under the proposal, however, Social Security recipients who are not currently saving for retirement might make contributions to qualified tuition programs because they want to save for their grandchildren's (or other relatives') college education, even though they do not believe they need additional retirement savings. As a result, some expect that Social Security recipients will be responsible for a greater percentage of any new aggregate savings resulting from the proposal than they are responsible for under present law. In such a case, some believe it is appropriate to more accurately measure economic income so as to better target the saving's incentive.

In certain cases, however, the proposal's treatment of excluded Social Security benefits may reduce or eliminate any additional incentive to save otherwise created by the proposal. Taxpayers who receive excluded Social Security benefits who might otherwise be motivated to contribute to qualified tuition programs under the proposal might discover that they will be entitled to a smaller Saver's credit than if they made contributions to a retirement plan, if they even still qualify for a Saver's credit. For these taxpayers, the proposal may not provide any further incentive to save, whether for retirement (for which there is already an incentive under present law) or for higher education expenses.

The proposal includes a limitation on a taxpayer's aggregate contribution to qualified tuition programs to which the credit applies. The proposal provides that the contribution cannot exceed the taxpayer's includible compensation, if less than $2,000, or, in the case of married individuals filing a joint return, if the combined includible compensation of the spouses is less than $4,000. This limitation is necessary to provide comparable treatment, for Saver's credit purposes, for contributions to qualified tuition programs and contributions to retirement plans. Under present law, the Saver's credit does not include any similar compensation-based limitation on contributions to retirement plans because the individual tax provisions governing each of those retirement plans separately include such a limitation. By contrast, the present law governing qualified tuition programs contains no compensation-based limitation on contributions. If the proposal did not include a compensation-based limitation for qualified tuition program contributions, a taxpayer with no earned income might qualify for the Saver's credit by making a contribution to a qualified tuition program. Allowing a credit in such a case might be considered an inappropriate tax incentive if the taxpayer already has sufficient unearned income (including, perhaps, interest, dividends, and capital gains) that the taxpayer does not need to work. Further, it might indicate that the taxpayer is merely shifting savings instead of undertaking additional savings.

Prior Action

A similar proposal was contained in the President's fiscal year 2008 budget proposal.

3. Allow use of qualified mortgage bonds to refinance home mortgages for subprime borrowers

Present Law

In general

Private activity bonds are bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes qualified mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds are bonds issued to make mortgage loans to certain homebuyers. Qualified mortgage bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or refinance existing mortgages. The Code imposes several additional limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the home financed with bond proceeds, and a "first-time homebuyer" requirement. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed

with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence.

The "first-time homebuyer" requirement provides that qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage. The first-time homebuyer requirement does not apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress.

As with most qualified private activity bonds, qualified mortgage bonds are subject to annual State volume limitations (the "State volume cap"). For calendar year 2008, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $262.09 million, if greater.

If an issuing authority's allocation of the State volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority generally may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.[184] A carryforward of unused volume cap is valid for three years.

Description of Proposal

The proposal authorizes the use of qualified mortgage bonds to refinance loans of eligible subprime borrowers in 2008, 2009, and 2010. The proposal generally describes "eligible subprime borrowers" as individuals with loans with a reasonably foreseeable risk of default and a reasonable potential to avoid default with a lower cost of refinancing. However, the proposal provides discretion to State and local government issuers to tailor subprime refinancing programs to local needs.

The proposal authorizes an additional $15 billion of State volume cap for the limited purpose of issuing qualified mortgage bonds to refinance loans of eligible subprime borrowers. The additional volume cap is allocated to each State in the same proportion as the present-law State volume cap. Additional volume cap allocated under the proposal may only be used in calendar years 2008, 2009, and 2010.

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

[184] Sec. 146(f)(5).

Analysis

The purpose of the qualified mortgage bond program is to expand home ownership by lowering mortgage costs for homebuyers through the use of tax-exempt financing. To minimize inefficiencies and restrict revenue loss, however, present law imposes restrictions on the program that are intended to direct the subsidy to those most in need of housing assistance.[185] For example, the income and purchase price requirements reflect Congressional intent to target the subsidy to low- and middle-income homebuyers. In addition, the first-time homebuyer requirement further restricts the subsidy to individuals who do not have a present ownership in a principal residence.

The proposal creates temporary exceptions to the new mortgage and first-time homebuyer requirements for qualified mortgage bonds and specifically authorizes such bonds to be used to refinance subprime loans.[186] Proponents argue refinancing authority is warranted on a temporary basis to alleviate the financial difficulties faced by the large number of homeowners with subprime adjustable rate mortgages that are due to reset over the next several years.[187] Recent declines in housing prices and a general deterioration of the credit markets are additional factors making it difficult for subprime borrowers to refinance adjustable rate mortgages and are cited as justification for providing additional temporary tax incentives. The subsidy provided by tax-exempt bonds, it is argued, will allow State and local governments to offer homeowners with subprime loans lower cost refinancing options than otherwise available under current market conditions. Further, proponents argue that the proposal is consistent with the general purpose of the qualified mortgage bond program to the extent it allows homeowners who may otherwise lose their home to foreclosure to retain ownership by lowering their borrowing costs.

Some opponents of the proposal argue that Federal resources should not be used to help bail out subprime borrowers or the current holders of the loans at risk of nonpayment. They argue that the current subprime crisis is largely the result of excessive risk taking on the part of financial institutions and in many cases the subprime borrowers themselves, and that government intervention will retroactively reward such improvident behavior as well as increase the incentives to undertake such behavior in the future.

Other opponents argue that it is not clear that the benefits of the proposal will be realized by homeowners who do not have access to other sources of credit and, thus, face the greatest risk of defaulting on an existing mortgage. The proposal provides broad discretion to State and local

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[185] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, December 31, 1982, at 120.

[186] Although not defined by the proposal, a subprime loan generally refers to loans for persons with blemished or limited credit histories. Such loans carry a higher rate of interest than prime loans to compensate for increased credit risk.

[187] Treasury estimates that 1.8 million subprime adjustable rate mortgages are due to reset over the next two years. United States Treasurer Anna Escobedo Cabral, *Remarks on Housing before the National Association of Hispanic Media*, HP-825 (Feb. 13, 2008).

governments to define the class of subprime borrowers that would be eligible for tax-exempt bond financing. Although some argue that this flexibility allows local governments to design programs that best meet the needs of the local community, the lack of clear eligibility requirements increases the risk that the subsidy will not be delivered as intended. Moreover, there are likely to be practical limitations to the ability of State and local governments to refinance the loans of many subprime borrowers. Subprime borrowers, particularly those who face a "reasonably foreseeable risk of default," as the proposal specifies, may not satisfy the loan underwriting standards of some State and local housing agencies. To the extent such subprime borrowers do satisfy State and local lending criteria, however, investors in bonds secured by such loans are likely to demand a premium to compensate for the additional risk of default. The risk premium associated with bonds secured by mortgages made to subprime borrowers may make it difficult for issuers to realize, and pass through to borrowers, the benefits generally associated with tax-exempt financing. Thus, as a result of both practical and legal impediments to providing financing to subprime borrowers, the refinancing authority ultimately may be used by those who otherwise would have access to credit. In that case, the proposal would not accomplish the goal of maintaining current levels of home ownership.

The proposal also provides for additional State volume cap for the purpose of issuing qualified mortgage bonds to refinance subprime loans. Proponents argue that a temporary increase in volume cap is necessary to address the current subprime mortgage crisis without reducing the amount of present-law volume cap available for new mortgages under the existing program. Proponents also argue that the volume cap available for other private activity bond programs, such as multifamily housing bonds and small issue bonds, should not be used to address this temporary housing emergency. On the other hand, the imposition of a unified volume cap in the 1986 Act was intended to allow State and local governments the flexibility to allocate the limited Federal subsidy for tax-exempt private activity bonds among qualifying activities as needs change. Moreover, as a result of recently enacted increases in the volume cap, many States have had unused issuance authority in recent years. Thus, rather than providing additional volume cap for refinancing purposes, some may argue it would be more efficient for the States to determine the local need for qualified mortgage bonds for refinancing and reallocate existing volume cap accordingly.

Prior Action

No similar proposals have been included in recent budget proposals of the President. A similar provision was included in S. 2517, introduced in the 110th Congress, 1st session.

F. Environment and Conservation Related Provisions

1. Permanently Extend Expensing of Brownfields Remediation Costs

Present Law

Section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Under section 198 of the Code, 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 or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in Commissioner v. Idaho Power Co.[188] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a

[188] 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under this provision.

Eligible expenditures under section 198 of the Code are generally those paid or incurred before January 1, 2008. The Gulf Opportunity Zone Act of 2005[189] added section 1400N(g) to the Code, which extended for two years (through December 31, 2007) the expensing of environmental remediation expenditures paid or incurred to abate contamination at qualified contaminated sites located in the Gulf Opportunity Zone. As a result of changes to section 198 contained in the Tax Relief and Health Care Act of 2006,[190] eligible expenditures covered under both section 1400N(g) and section 198 must be paid or incurred prior to January 1, 2008.

Description of Proposal

The proposal eliminates the requirement that expenditures must be paid or incurred before January 1, 2008, to be deductible as eligible environmental remediation expenditures. Thus, the provision becomes permanent.

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

Analysis

The proposal to make permanent the expensing of brownfields remediation costs promotes the goal of environmental remediation and removes doubt as to the future deductibility of remediation expenses. Removing the doubt about deductibility may be desirable if the present-law expiration date is currently affecting investment planning. For example, the temporary nature of relief under present law may discourage projects that require a significant ongoing investment, such as groundwater clean-up projects. On the other hand, extension of the provision for a limited period of time would allow additional time to assess the efficacy of the law, adopted as part of the Taxpayer Relief Act of 1997, prior to any decision as to its permanency.

The proposal is intended to encourage environmental remediation, and general business investment, at contaminated sites. With respect to environmental remediation tax benefits as an incentive for general business investment, it is possible that the incentive may have the effect of distorting the location of new investment, rather than increasing investment overall.[191] If the

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[189] Pub. L. No. 109-135 (2005).

[190] Pub. L. No. 109-432 (2006).

[191] For a discussion of the economic effects of targeting economic activity to specific geographic areas, see Leslie E. Papke, "What Do We Know About Enterprise Zones," in James M. Poterba, ed., *Tax Policy and the Economy, vol. 7* (Cambridge, MA: The MIT Press), 1993.

new investments are offset by less investment in neighboring, but not qualifying, areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

By making the present law provision permanent, the proposal may simplify tax planning and investment planning by taxpayers by providing more certainty. However, in general, the proposal treats expenditures at certain geographic locations differently from otherwise identical expenditures at other geographic locations. Such distinctions generally require additional record keeping on the part of taxpayers and more complex tax return filings. Concomitantly, such distinctions increase the difficulty of IRS audits.

Prior Action

Proposals to make section 198 permanent were included in the President's fiscal year 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007 and 2008 budget proposals.

2. Eliminate the volume cap for private activity bonds for water infrastructure

Present Law

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Interest on State or local bonds issued to finance activities of private persons is taxable unless issued for certain purposes permitted by the Code ("qualified private activity bonds").

The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bonds.[192] The definition of an exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); low-income residential rental property; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; and, qualified green building/sustainable design projects.[193]

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations ("State volume cap").[194] For calendar year 2008, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $262.09 million, if greater. Exceptions from the State volume cap are provided for bonds issued for certain governmentally

[192] Sec. 141(e).

[193] Sec. 142(a).

[194] Sec. 146.

owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

If an issuing authority's State volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority generally may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.[195] A carryforward of unused State volume cap is valid for three years.

Since the 1987 amendments to the Clean Water Act, many States have established State revolving fund programs ("SRFs") to finance wastewater and drinking water projects. SRFs are pools of capital dedicated to financing public infrastructure formed through Federal and state contributions. SRFs use Federal grants to make loans to local governments to finance the construction of water facilities and to establish debt service reserve funds for bonds the proceeds of which are so be used to make such loans. Although present law generally prohibits the Federal guarantee of tax-exempt bonds,[196] the IRS has ruled that States may use Federal grants to fund debt service reserve funds for tax-exempt bonds issued to finance SRF loans without affecting the tax-exempt status of such bonds.[197]

Description of Proposal

The proposal provides an exception to the State volume cap for tax-exempt bonds issued to finance privately used or operated facilities for the furnishing of water or sewage facilities.

Effective date.–The proposal is effective for bonds issued after December 31, 2008.

Analysis

Under present law, local governments are not limited in the amount of tax-exempt bonds that may be issued to finance water or sewage facilities, provided such facilities are governmentally owned and operated. In contrast, water or sewage facilities that both are financed with tax-exempt bonds and privately owned or operated are subject to the State volume cap. The proposal would expand the opportunities to use tax-exempt debt to finance such

[195] Sec. 146(f)(5).

[196] Sec. 149(b).

[197] Notice 88-54, 1988-1 C.B. 539.

facilities in so-called public-private partnerships, where a private person owns and operates the facilities or where a private person operates the facilities.

The State volume cap reflects the intent of Congress to control the volume of tax-exempt bonds issued for private activities. Moreover, the imposition of a unified volume cap in the 1986 Act, in place of the separate limitations imposed on different categories of private activity bonds under prior law, was intended to allow State and local governments the flexibility to allocate the limited Federal subsidy among qualifying activities as needs change. However, every new category of private activity bond enacted since 1988 has been either wholly or partially exempt from the State volume cap.

Opponents of providing additional exceptions from the State volume cap argue such exceptions increase the amount of tax-exempt bonds issued for private parties. This may result in higher borrowing costs for all issuers of tax-exempt bonds due to increased competition for the limited pool of assets for investment in such obligations. Moreover, in recent years, Congress has raised the State volume cap limits and indexed the cap for inflation. As a result of the increases in the cap, many States have had unused issuance authority in recent years. With excess State volume cap available to issuers, opponents may argue there is less of a need to provide exceptions to the cap for specific activities.

Proponents, however, argue that water and sewage facilities serve important policy interests in ensuring the availability of drinking water and sanitation. The State volume cap restrictions force these projects to compete for limited allocations. Eliminating the volume cap provides State and local governments with additional flexibility to finance such projects without competing with other private projects for volume cap allocation. On the other hand, some may question whether it is appropriate to except these projects from volume cap, while maintaining the cap for other types of public-private projects that also provide benefits to the general public. Generally, different volume cap rules for different types of projects may result in inefficient allocations of capital because it distorts the State and local government decision-making process of allocating the subsidy provided through tax-exempt financing to projects that may provide the greatest benefit. This is precisely the situation Congress intended to eliminate when enacting the unified volume cap.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposals.

G. Restructure Assistance to New York

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is 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. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[198]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.[199] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

For property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[200] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property[201] and (2) property eligible for the additional first-year depreciation deduction under

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[198] In addition to the NYLZ provisions described above, the following NYLZ provisions expired in 2006: five-year recovery period for depreciation of certain leasehold improvements, increase in expensing under sec. 179, and extended replacement period for nonrecognition of gain under sec. 1033.

[199] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

[200] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

[201] Qualified NYLZ leasehold improvement property is defined as qualified leasehold improvement property located in the New York Liberty Zone, placed in service after September 10, 2001 and before January 1, 2007, and for which no written binding contract was in effect before September 11, 2001 (sec. 1400L(c)(2)). Leasehold improvements that do not satisfy the requirements to be treated as

section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[202] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For nonresidential real property and residential rental property to qualify, it must be placed in service on or before December 31, 2009, rather than December 31, 2006. Property does not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.[203]

Nonresidential real property and residential rental property is eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[204] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Description of Proposal

Repeal of certain NYLZ incentives

The proposal repeals the NYLZ incentive for the additional first-year depreciation allowance of 30 percent for nonresidential real property and residential rental property.

Effective date.–The proposal is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law.

"qualified NYLZ leasehold improvement property" maybe eligible for the 30 percent additional first-year depreciation deduction (if all other requirements are met).

[202] For purposes of this provision, purchase is defined as under section 179(d).

[203] Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

[204] December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

Credit for certain payments of New York State and New York City

The proposal provides a Federal tax credit to New York State and New York City for expenditures relating to construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. The amount of the credit in each year, 2009 through 2018, may not exceed the lesser of (1) $200 million per year (divided equally between the State and the City), until a cumulative total of $2 billion is reached, or (2) expenditures for the calendar year by the State or City, respectively, relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. Any amount of unused credit below the $200 million annual limit is carried forward to the following year, including years after 2018, and expenditures that exceed the $200 million annual limit are carried forward and subtracted from the $200 million annual limit in the following year.

The credit would be allowable against any payment by the State or City to the Federal government required under a provision of the Internal Revenue Code other than the provisions relating to payments of excise taxes, FICA, SECA, or OASDI amounts. For example, the credit is allowable against payments of Federal income tax withheld with respect to State or City employees.

Treasury guidance is to be provided to ensure that the expenditures satisfy the intended purposes. The amount of the credit is treated as State and local funds for purposes of any Federal program.

Effective date.–The proposal is effective for calendar years after 2008.

Analysis

The proposal is based on the premise that some of the tax benefits provided by the present-law incentive provisions will not be usable in the form in which they were originally provided, and that they should be replaced with other benefits which would have a greater impact on the recovery and continued development in the NYLZ. The proposal reflects a preference for subsidizing transportation infrastructure rather than buildings and other private property. Even to the extent that the incentive provisions can be used by taxpayers in their present-law form, they are unnecessary to spur investment in the NYLZ because, it is argued, investment would occur in the area even without special tax incentives.

On the other hand, the effectiveness of the present-law NYLZ incentives may not yet be determinable because insufficient time has passed since they were enacted. Furthermore, repeal of the provisions prior to their scheduled expiration could be unfair to any taxpayers who have begun, in reliance upon the incentive provisions, to implement long-term plans the status of which requires them to continue with planned investments despite the absence of a written binding contract. Opponents may also object to the replacement of a benefit for private taxpayers with a cash grant to governmental entities, or the replacement of an incentive for investment in private property with an incentive for investment in public infrastructure. Further, it could be argued that the transportation infrastructure might be built without the incentive provided under the proposal, just as investment in the NYLZ is taking place without regard to tax incentives.

The proposal could be criticized as creating an inefficient method for delivering a Federal transportation infrastructure subsidy to New York State and New York City. Further, because neither New York City nor New York State is subject to Federal income tax itself, administration of the Federal tax law is made needlessly complex by the creation of a credit against payment of withheld income tax of these governmental entities' employees. Providing a transportation infrastructure subsidy as a direct grant outside of the tax law would be more consistent with simplification of the tax law and administrative efficiency.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, and 2008 budget proposals. These prior proposals included the repeal of certain other NYLZ incentives not already expired.

III. SIMPLIFY THE TAX LAWS FOR FAMILIES

A. Clarify Uniform Definition of Child

Present Law

Uniform definition of qualifying child

In general

Present law provides a uniform definition of qualifying child (the "uniform definition") for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. A taxpayer generally may claim an individual who does not meet the uniform definition (with respect to any taxpayer) as a dependent if the dependency requirements are satisfied. The uniform definition generally does not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children of the taxpayer qualify for each tax benefit.

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

The support and gross income tests for determining whether an individual is a dependent generally do not apply to a child who meets the requirements of the uniform definition.

Residency test

Under the uniform definition's residency test, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, are not treated as absences.

Relationship test

In order to be a qualifying child, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. For purposes of determining whether an adopted child is treated as a child by blood, an adopted child means an individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.

Age test

The age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child. In general, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. A child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit, and under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

A child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. However, a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income credit.

Tie-breaking rules

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

Interaction with other rules

Taxpayers generally may claim an individual who does not meet the uniform definition with respect to any taxpayer as a dependent if the dependency requirements (including the gross income and support tests) are satisfied. Thus, for example, a taxpayer may claim a parent as a dependent if the taxpayer provides more than one half of the support of the parent and the parent's gross income is less than the personal exemption amount. As another example, a grandparent may claim a dependency exemption with respect to a grandson who does not reside with any taxpayer for over one half the year, if the grandparent provides more than one half of the support of the grandson and the grandson's gross income is less than the personal exemption amount.

Children of divorced or legally separated parents

A custodial parent may release the claim to a dependency exemption (and, therefore, the child credit) to a noncustodial parent. Thus, custodial waivers that are in place and effective on the date of enactment of the Working Families Tax Relief Act of 2004 (Pub. L. No 108-311), will continue to be effective after such date of enactment, if they continue to satisfy the waiver rule. In addition, the custodial waiver rule applies for purposes of the dependency exemption

(and, therefore, the child credit) for decrees of divorce or separate maintenance or written separation agreements that become effective after the date of enactment. The custodial waiver rules do not affect eligibility with respect to children of divorced or legally separated parents for purposes of the earned income credit, the dependent care credit, and head of household filing status.

If a waiver is made, the waiver applies for purposes of determining whether a child meets the definition of a qualifying child or a qualifying relative under section 152(c) or 152(d) as amended by the provision. While the definition of qualifying child is generally uniform, for purposes of the earned income credit, head of household status, and the dependent care credit, the uniform definition is applied without regard to the waiver provision. Thus, a waiver that applies for the dependency exemption will also apply for the child credit, and the waiver will not apply for purposes of the other provisions.

Other provisions

A taxpayer identification number for a child must be provided on the taxpayer's return. For purposes of the earned income credit, a qualifying child is required to have a social security number that is valid for employment in the United States (that is, the child must be a U.S. citizen, permanent resident, or have a certain type of temporary visa).

Dependency rules

In general

An individual may be claimed as a taxpayer's dependent if such individual is a qualifying child or a qualifying relative of the taxpayer and meets certain other requirements. An individual is a taxpayer's qualifying relative if such individual (1) bears the appropriate relationship to the taxpayer; (2) has a gross income that does not exceed the personal exemption amount; (3) receives one-half of his or her support from the taxpayer; and (4) is not a qualifying child of the taxpayer. Generally, an individual bears the appropriate relationship to the taxpayer if the individual is the taxpayer's lineal descendent or ancestor, brother, sister, aunt, uncle, niece, or nephew. Some relations by marriage also qualify, including stepmothers, stepfathers, stepbrothers, stepsisters, sons-in-law, daughters-in-law, fathers-in-law, mothers-in-law, brothers-in-law, and sisters-in-law. In addition, an individual bears the appropriate relationship if the individual has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.

Dependents of dependents

Generally, if an individual is a dependent of a taxpayer for any taxable year, such individual is treated as having no dependents for such taxable year. Therefore, the individual is ineligible to claim:

(1) head of household filing status;[205]

(2) the dependent care credit;[206] or

(3) a dependency exemption.[207]

Married dependents

Generally, an individual filing a joint return with such individual's spouse is not treated as the dependent of a taxpayer. Therefore, the taxpayer is ineligible to claim the earned income credit or a dependency exemption with respect to such individual.

Citizenship and residency

Children who are U.S. citizens or nationals living abroad or non-U.S. citizens or nationals living in Canada or Mexico may qualify as dependents. In addition, a legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a dependent if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States.

Earned income credit

The earned income credit is a refundable tax credit available to certain lower-income individuals. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, and the number of qualifying children.

An individual who is a qualifying child of another individual is not eligible to claim the earned income credit. Thus, in certain cases a taxpayer caring for a younger sibling in a home with no parents would be ineligible to claim the earned income credit based solely on the fact that the taxpayer is a qualifying child of the younger sibling if the taxpayer meets the age, relationship, and residency tests.

Description of Proposal

Limit definition of qualifying child

The proposal adds a new requirement to the uniform definition. Specifically, it provides that an individual who otherwise satisfies the uniform definition is not treated as a qualifying child unless he or she is either: (1) younger than the individual claiming him or her as a qualifying child or (2) permanently and totally disabled. In addition, the proposal provides that

[205] Sec. 2.

[206] Sec. 21.

[207] Sec. 151.

an individual who is married and files a joint return (unless the return is filed only as a claim for a refund) will not be considered a qualifying child for child-related tax benefits, including the child tax credit.

Restrict qualifying child tax benefits to child's parent

The proposal provides that if a parent resides with a qualifying child for more than half the taxable year then only the parent can claim the child as a qualifying child. However, the parent could allow another member of the household to claim the qualifying child if the other individual: (1) has a higher adjusted gross income for the taxable year; and (2) otherwise is eligible to claim the qualifying child. The proposal further provides that dependent filers are not eligible for child-related tax benefits.

Effective date

The proposal is effective for taxable years beginning after December 31, 2008.

Analysis

In general

The proposed changes to the uniform definition are intended to restore eligibility for the earned income credit[208] to certain lower-income siblings while eliminating a tax planning opportunity for more affluent families. As discussed below, each element of the proposal would achieve its intended result. However, the proposal would also constitute the third change in the earned income credit eligibility requirements since 2001. The earned income credit eligibility requirements were changed by Economic Growth and Tax Relief Reconciliation Act of 2001 and the Working Families Tax Relief Act of 2004. Beneficiaries of the earned income credit are more likely to be less sophisticated than other taxpayers. For this reason, changes to the uniform definition may adversely affect the ability of lower income individuals to understand their eligibility for child-related benefits such as the earned income credit. This is particularly important in an area that has a history of high taxpayer error rates.

Limit definition of qualifying child

The first part of the proposal is intended to restore eligibility for the earned income credit to certain individuals. It applies to certain working lower-income siblings with respect to their siblings where no other taxpayers reside in the household. Under present law, such siblings would be ineligible for the earned income credit to the extent they could each be the qualifying child of the other. For example, a 20-year-old woman who works 30 hours per week but is also a full-time student and the legal guardian of her 15-year-old brother would be unable to claim him as her qualifying child. It can be argued that denying the earned income credit in such a case was an unintended consequence of the enactment of a uniform definition. Further, the earned income credit arguably is intended to provide assistance in this kind of situation.

[208] The proposal may also affect eligibility for other tax benefits.

One situation that would not benefit from the proposal would be a circumstance where a younger sibling is supporting an older sibling. Such a situation may arise, for example, where a younger sibling is working but the older sibling is a full-time student. The proposal could have addressed this circumstance and restored eligibility for the earned income credit to this group by denying status as a qualifying child to siblings with higher incomes rather than to siblings that are older.

Some child-related tax benefits, such as the dependency exemption, are already restricted where an individual is married and files a joint return. The proposal extends this limitation by excluding all joint filers (with a narrow exception for taxpayers who file jointly only as a claim for refund) from the uniform definition. This change would affect only a small percentage of filers (such as married teenagers filing joint returns) but would reduce complexity by eliminating the need to file a special form in cases where a qualifying child under the uniform definition is not a dependent.

Restrict qualifying child tax benefits to child's parent

Under certain fact patterns (e.g., certain multi-generational families), where more than one taxpayer within a family can claim a qualifying child for certain tax benefits, the members of the family may arrange their affairs to maximize their tax benefits. This planning opportunity was available in the case of the earned income credit before the enactment of the uniform definition in 2004. The enactment of the uniform definition potentially expanded this planning opportunity among earned income credit claimants and also extended the planning opportunity to other child-related tax benefits. For example, if a grandparent, parent, and child share the same household, under present law the grandparent and parent can decide which of them should claim the qualifying child in order to maximize tax benefits. If the parent earns $40,000 a year and the grandparent $20,000, it may be more advantageous for the grandparent to claim the qualifying child in order to receive the earned income credit, which the parent is ineligible due to his level of earnings. Under the proposal, the grandparent could not claim the qualifying child because his adjusted gross income is less than that of the parent.

The uniform definition has another, arguably unintended consequence. In certain fact patterns, the uniform definition extends tax benefits to certain families who otherwise would not qualify (e.g. when the parents' income exceeds otherwise applicable income levels) or increases benefits to certain qualifying families. For example, it may be possible in certain circumstances and financially advantageous for the family as a whole, for parents to forgo claiming a child as a qualifying child so that an older child living at home may claim such child as a qualifying child. This would be most advantageous in circumstances in which the parents have income above the phaseout limits for the child credit or where the older sibling becomes eligible for the earned income credit by claiming the younger sibling as a qualifying child.

Under the circumstances described above, the uniform definition provides a tax planning opportunity for families that are more affluent and arguably less in need of a tax benefit. The proposal addresses these situations by limiting the ability of a non-parent to claim a child as a qualifying child when the child lives with his or her parents for over half the year.

The proposal also restricts dependent filers from being eligible for child-related tax benefits. The result of this would be to extend the limitation already imposed with respect to the dependency exemption to other child-related tax benefits.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007 and 2008 budget proposals.[209]

[209] The 2006 budget proposal, however, did not include the proposal to exclude from the definition of qualifying child married individuals filing a joint return. In addition, the 2006 budget proposal did not exclude dependent filers from child-related tax benefits.

B. Simplify EIC Eligibility Requirements Regarding Filing Status, Presence of Children, and Work and Immigrant Status

Present Law

Overview

Low and moderate-income workers may be eligible for the refundable earned income credit (EIC). Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The earned income credit generally equals a specified percentage of earned income[210] up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI)), if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,950 (for 2008). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year shall not be considered as married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that

[210] Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,[211] and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

The EIC is available to low and moderate-income working taxpayers. Three separate schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, and one schedule for taxpayers with more than one qualifying child.[212]

Taxpayers with one qualifying child may claim a credit in 2008 of 34 percent of their earnings up to $8,580, resulting in a maximum credit of $2,917. The maximum credit is available for those with earnings between $8,580 and $15,740 ($18,740 if married filing jointly). The credit begins to phase down at a rate of 15.98 percent of earnings above $15,740 ($18,740 if married filing jointly). The credit is phased down to $0 at $33,995 of earnings ($36,995 if married filing jointly).

Taxpayers with more than one qualifying child may claim a credit in 2008 of 40 percent of earnings up to $12,060, resulting in a maximum credit of $4,824. The maximum credit is available for those with earnings between $12,060 and $15,740 ($18,740 if married filing jointly). The credit begins to phase down at a rate of 21.06 percent of earnings above $15,740 ($18,740 if married filing jointly). The credit is phased down to $0 at $38,646 of earnings ($41,646 if married filing jointly).

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $5,720, resulting in a maximum credit of $438, for 2008. The maximum is available for those with incomes between $5,720 and $7,160 ($10,160 if married filing jointly). The credit begins to phase down at a rate of 7.65 percent of earnings above $7,160 ($10,160 if married filing jointly) resulting in a $0 credit at $12,880 of earnings ($15,880 if married filing jointly).

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EIC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EIC with respect to the qualifying child. The eligible taxpayer who does not claim the EIC with respect to the qualifying child may not claim the EIC for taxpayers without qualifying children.

Definition of qualifying child

Present law provides a uniform definition of qualifying child (the "uniform definition") for purposes of the dependency exemption, the child credit, the earned income credit, the

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[211] A foster child must reside with the taxpayer for the entire taxable year.

[212] All income thresholds are indexed for inflation annually.

dependent care credit, and head of household filing status. The uniform definition generally does not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children of the taxpayer qualify for each tax benefit. Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Taxpayer identification number requirements

Individuals are ineligible for the credit if they do not include their taxpayer identification number (TIN) and their qualifying child's TIN (and, if married, their spouse's TIN) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a TIN is defined as a Social Security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act regarding the issuance of a number to an individual applying for or receiving federally funded benefits. If an individual fails to provide a correct taxpayer identification number, such omission will be treated as a mathematical or clerical error by the IRS.

A taxpayer who resides with a qualifying child may not claim the EIC with respect to the qualifying child if such child does not have a valid TIN. The taxpayer also is ineligible for the EIC for workers without children because he or she resides with a qualifying child. However, if a taxpayer has two or more qualifying children, some of whom do not have a valid TIN, the taxpayer may claim the EIC based on the number of qualifying children for whom there are valid TINs.

Description of Proposal

Overview

The proposal modifies present law EIC rules by (1) altering the rules with respect to EIC claims made by separated spouses;[213] (2) simplifying the rules regarding claiming the EIC for workers without children; and (3) changing the taxpayer identification number requirements for taxpayers and their qualifying children with respect to the EIC.

Claims by separated spouses

The proposal modifies present law regarding EIC claims made by separated spouses. Under the proposal, a married taxpayer who files a separate return (as married filing separately) is allowed to claim the EIC if he or she lives with a qualifying child for over half the year, provided the taxpayer lives apart from his or her spouse for the last six months of the taxable

[213] Secs. 32(d) and 7703(b).

year and otherwise satisfies the generally applicable EIC provisions.[214] Under the proposal, a married taxpayer who satisfies these requirements, and files as married filing separately, is not required to provide over half the cost of maintaining the household in which the qualifying child resides.

Claims for EIC for workers without children

The proposal modifies the rules for EIC claims made by multiple taxpayers residing in the same principal place of abode in which a qualifying child resides. Under the proposal, if multiple taxpayers residing in the same principal place of abode are eligible to claim the same qualifying child, an otherwise eligible taxpayer may claim the EIC for workers without children (maximum credit of $438 for 2008) even if another taxpayer within the same principal place of abode claims the EIC with respect to the qualifying child. However, if unmarried parents reside together with their child or children (sons, daughters, stepchildren, adopted children, or foster children), then one parent may claim the EIC for taxpayers with qualifying children, but neither parent may claim the EIC for workers without children.[215]

TIN requirements

The proposal provides that 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, the taxpayer must be a United States citizen, permanent resident, or have a certain type of temporary visa that allows him to work in the United States). Under the proposal, taxpayers who receive Social Security numbers for non-work reasons, such as for purposes of receiving Federal benefits or for any other reason, are not eligible for the EIC. The proposal also provides that if a qualifying child does not have a valid TIN, a taxpayer is eligible to claim the EIC for workers without children (maximum credit of $438 for 2008).

Effective date.–The proposal generally is effective for taxable years beginning after December 31, 2008.

Analysis

Claims by separated spouses

The proposal eliminates the household maintenance test for a separated spouse who claims the EIC. Married taxpayers filing separate returns who reside with qualifying children may claim the EIC if they live apart from their spouse for the last half of the year. As under present law, such a taxpayer could not file as a head of household unless he or she also satisfies a

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[214] The proposal adopts the qualifying child test for this purpose, rather than the "dependent child" test that applies under present law.

[215] Both under the proposal and present law, unmarried parents who reside together with multiple qualifying children who are their sons, daughters, stepchildren, adopted children, or foster children, may allocate the qualifying children between them for earned income credit purposes.

household maintenance test and resides with a dependent child. This proposal simplifies the determination of whether a separated spouse is eligible to claim the earned income credit, and increases the number of separated spouses living with a qualifying child who could claim the EIC for taxpayers with qualifying children.

Claims for EIC for workers without children

Some may argue that the proposal to permit a taxpayer to claim the EIC for taxpayers without qualifying children (maximum of $438 for 2008) in cases where the taxpayer has a qualifying child, but another taxpayer claims the qualifying child for EIC purposes, has the potential to add administrative complexity for both taxpayers and the IRS. Under the proposal, each eligible taxpayer has an incentive to calculate his or her taxes under two alternatives to determine the maximum aggregate EIC available to the multiple taxpayers who could claim the qualifying child: one alternative in which the taxpayer claims the qualifying child for the EIC (and the other taxpayer claims the EIC for taxpayers without qualifying children), and one in which the taxpayer claims the EIC without the qualifying child (and the other taxpayer claims the EIC for taxpayers with a qualifying child). Presumably the taxpayers would wish to select that filing combination that yields the lowest tax cost, or the highest tax benefit, to the parties. The proposal provides flexibility to taxpayers so that they are able to allocate the qualifying child to a taxpayer in a manner that maximizes the aggregate earned income credit, and may increase the aggregate credit paid when compared to present law, but might do so at the cost of increasing the complexity of the tax system. Others may argue that the proposal does not increase selectivity or materially increase complexity, because multiple taxpayers who are eligible to claim the same qualifying child for the EIC currently have an incentive to calculate their taxes under two alternatives (each computes the EIC for qualifying children, but not the EIC for taxpayers without qualifying children) to yield the lowest tax cost or the highest tax benefit for the parties.

The proposal's adoption of different rules for unmarried parents than for other taxpayers who reside with a qualifying child in the same residence creates complexity and places unmarried parents at a disadvantage when compared with other types of extended family situations (e.g., a mother and grandmother sharing the same principal place of abode with a qualifying child).

TIN requirements

The proposal permits a taxpayer to claim the EIC for taxpayers without a qualifying child (maximum credit of $438 for 2008) if the taxpayer has a qualifying child who does not have a valid TIN. The proposal has the effect of reducing the amount of the lost tax benefit associated with failing to satisfy the TIN requirement for a qualifying child. Some may argue that this is equitable because it treats a taxpayer with a qualifying child who lacks a valid TIN in the same manner as a taxpayer who does not have a qualifying child. Others may argue that in some cases the proposal reduces the incentive for a taxpayer to obtain a valid TIN for a qualifying child.

The proposal also requires that taxpayers (including spouses) claiming the EIC have Social Security numbers that are valid for employment in the United States.[216] This has the effect of denying the EIC to some taxpayers who have valid TINs and are currently eligible to claim the credit but who are not authorized to work in the United States. Proponents of the proposal may argue that individuals who are not authorized to work in the United States should not be eligible to claim the EIC.

Prior Action

A similar proposal was included in the President's fiscal year 2005, 2007, and 2008, budget proposals.[217]

[216] The proposal (like the 2007 budget proposal) does not require that qualifying children have Social Security numbers authorizing them to work in the United States.

[217] The 2005 budget proposal, however, required that taxpayers and any qualifying children have Social Security numbers that were valid for employment in the United States.

C. Reduce Computational Complexity of Refundable Child Tax Credit

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000 through 2010. A child who is not a citizen, national, or resident of the United States may not be a qualifying child.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of 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. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of $12,050 (the "earned income" formula). The threshold dollar amount is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit ("EIC").

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Residents of U.S. possessions (e.g., Puerto Rico) are generally not eligible for the refundable child credit, because the earned income formula is based on earned income to the extent the earned income is included in taxable income. Because residents of possessions are not subject to the U.S. income tax on income earned in the possessions, they are not generally eligible for the refundable child credit. However, the alternative child credit formula for taxpayers with three or more children is based on social security taxes, and thus residents of possessions with three or more children are eligible for the refundable child credit if they pay social security taxes, as do Puerto Ricans on Puerto Rican or U.S. source earnings.

Description of Proposal

The proposal repeals the alternative formula based on the excess of the social security taxes paid over the amount of the EIC. Thus, the additional child tax credit will be based solely on the earned income formula, regardless of the number of children in a taxpayer's family.

Also, the proposal eliminates the requirement that earned income be included in taxable income for purposes of computing the additional child tax credit. This conforms the definition of earned income for purposes of the refundable child credit and the EIC (i.e., earned income for both credits equals the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings). Thus, net self-employment earnings that are not included in taxable income will be included in earned income for purposes the additional child credit.

Finally, the proposal requires taxpayers to reside with a child in the United States to claim the additional child tax credit. For these purposes, the principal place of abode for members of the U.S. Armed Forces is treated as in the United States for any period the member is stationed outside the United States while serving on extended active duty. Extended active duty includes a call or order to such duty for a period in excess of 90 days.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2008.

Analysis

A single rule for calculating the refundable child credit will provide simplification for taxpayers with three or more children who otherwise must make two separate calculations: the earned income formula and the alternative formula. The vast majority of such taxpayers find that the alternative formula calculation does not yield a higher credit amount so its repeal would make the credit calculation simpler without materially changing total benefits. However, taxpayers for whom the alternative formula produces the greater benefit would receive a smaller refundable child credit than that provided by current law. In general, taxpayers who find the alternative formula more valuable are: (1) residents of Puerto Rico, who do not pay U.S. income taxes and are not eligible to claim the EIC, but who may nonetheless may file a U.S. income tax return to claim a refundable child credit, and (2) taxpayers in the United States who are eligible for the child credit but not eligible to claim the EIC.

Use of the same measure of earned income for both the refundable child credit and the EIC will provide simplification for all taxpayers claiming both credits. While for virtually all taxpayers the two measures of income yield the same result under present law, the fact that this is not true of all taxpayers requires that tax forms provide additional instructions for all. Taxpayers for whom the two measures of earned income differ are those who have certain self-employment earnings, such as a parsonage allowance, that are excluded from gross income for individual income tax purposes. The President's proposal to adopt the EIC definition of earned income for purposes of the refundable child credit (that is, to eliminate the requirement that the earned income be included in taxable income) will expand the availability of the refundable child credit to income not subject to the individual income tax, which some might view as an undesirable policy result. The modified definition would allow Puerto Ricans with fewer than three children

to claim the refundable child credit but for the President's related proposal that eligibility for the refundable credit be conditioned on United States residency (discussed below).

An alternative proposal that only modifies the EIC earned income definition by including only self-employment income that is included in gross income (as is the rule for non self-employment income) would appear to achieve similar simplification without affecting the child credit for residents of Puerto Rico with children. The alternative proposal would result in the same definition of earned income for purposes of the EIC and refundable child credit for all persons with self-employment earnings regardless of whether any self-employment earnings are excluded from gross income for income tax purposes (such as is the case for parsons with parsonage allowances). Additionally, the alternative proposal would treat employees and the self-employed equivalently in determining both the EIC and refundable child credit.

The President's proposal requires taxpayers to reside in the United States in order to claim the refundable child credit. The principal effect of this proposal is to prevent the expansion of the refundable child credit to residents of Puerto Rico with fewer than three children, and to citizens working abroad whose earned income is excludable (entirely or in part) under Code section 911, that would occur under the President's proposal to conform the earned income definition for purposes of the EIC and the refundable child credit. There does not appear to be any particular simplification that results from the proposal other than to prevent Puerto Ricans, who are not required to file a U.S. income tax return, from filing such a return for the sole purpose of claiming a refundable credit.

The President's proposal to require U.S. residency in order to claim a refundable child credit would deny the refundable child tax credit to certain taxpayers living abroad who may currently claim it. In some cases this may not be considered desirable, such as in the case of a low-income U.S. citizen who works in the U.S. but who happens to live in Canada or Mexico. In other cases the result may be viewed as desirable. For example, a married U.S. taxpayer with two children who lives and works in a foreign country with $107,600 foreign earned income would have a gross income of only $20,000 in 2008 as a result of the $87,600 foreign earned income (section 911) exclusion. As a result of other provisions of U.S. law such as the personal exemptions and child credits, such a taxpayer would have no U.S. income tax liability. However, because the refundable child credit is based on only earned income included in taxable income, the taxpayer is eligible for a refundable credit of 15 percent of the amount by which such income (in this case $20,000) exceeds $12,050, or $7,950, for a refundable credit of $1,192.50. Under present law, and under the proposal, the taxpayer is not eligible for the EIC. The policy for paying a refundable child credit in such a case is questionable, especially considering the refundable credit is only payable once the taxpayer's earned income reaches $99,650 ($87,600 section 911 exclusion plus refundable child credit earned income threshold of $12,050).

Another situation where present law leads to a potentially undesirable result occurs where a U.S. taxpayer with children has foreign tax liability and claims a foreign tax credit. In some such cases, such as a taxpayer working abroad who waives the section 911 exclusion, the taxpayer could pay the foreign tax, use the foreign tax credit to eliminate any U.S. tax liability, and then claim a refundable child credit. Under the proposal, the child credit would not be available to such a taxpayer.

Prior Action

A similar proposal was included in the President's fiscal year 2005, 2007, and 2008 budget proposals.

IV. IMPROVE TAX COMPLIANCE

A. Expand Information Reporting

1. Require information reporting on payments to corporations

Present Law

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[218] Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN").

Description of Proposal

The proposal requires businesses to file an information return for payments aggregating $600 or more in a calendar year to a corporation (except a tax-exempt corporation).

Effective date.−The proposal is effective for payments made to corporations on or after January 1, 2009.

Analysis

Requiring information reporting for payments aggregating $600 or more in a calendar year to a corporation could enhance taxpayer compliance and IRS enforcement efforts. Income that is subject to information reporting is less likely to be underreported. Moreover, it is easier for the IRS to detect the underreporting of income subject to information reporting. In contrast, the absence of information reporting on many types of payments results in underreporting of the related income and contributes to the tax gap.[219] In general, the more payments to which information reporting and/or withholding applies, the greater the improvement in compliance.

However, the compliance benefits from the proposal may be limited due to inconsistencies with the manner in which many corporations compute taxable income. For example, many corporations compute taxes on a fiscal year basis, whereas the proposal requires calendar year reporting for payments to corporations. To the extent a corporate taxpayer computes income on a fiscal year basis, calendar year information reporting may not accurately reflect income received during the corporation's taxable year. Similarly, a significant number of

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[218] Sec. 6041(a).

[219] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely.

corporations report income on an accrual basis, rather than a cash basis. For accrual basis taxpayers, the year in which the taxpayer receives a payment may not correspond to the year in which the taxpayer must include such payment in income.

Imposing additional information reporting requirements also will impose additional costs on businesses that should be weighed against the potential compliance benefits. The additional reporting requirements will increase the administrative burden on payors subject to the provision. The extent of this additional burden may depend on the extent to which taxpayers subject to the proposal have procedures and systems in place to meet present-law information reporting requirements that can be adapted to comply with the proposal. Proponents argue, however, that the widespread use of computer technology to process and store business information should minimize the burden associated with generating and transmitting the information necessary to comply with the proposal, regardless of the extent to which the taxpayer is currently subject to information reporting. Moreover, because payments to corporations are generally excepted from information reporting requirements, present law requires payors to determine whether a payee is a corporate or non-corporate taxpayer. To the extent the proposal reduces the instances in which payors must make this determination, the proposal may result in some simplification of present-law reporting requirements.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposal.

2. Require basis reporting on security sales

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization (for example, the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.[220]

To compute adjusted basis, a taxpayer first must determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.[221] The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and may be adjusted upward to reflect income and gain inclusions (to the extent that the taxpayer does not receive a corresponding payment) or capital outlays with respect to the property.

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[220] Sec. 1001.

[221] Sec. 1016.

Basis computation rules for stock

If a taxpayer has acquired lots of stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[222] If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[223] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.[224]

Information reporting

Present law imposes information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether taxpayers' tax returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[225]

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.[226] Brokers are required to furnish to every customer an information statement with the same gross proceeds information that is included in the return filed with the IRS for that customer.[227]

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of $50 for each return with respect to which such a failure occurs, up to a maximum of $250,000 in any calendar year.[228] Similar penalties, with a

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[222] Treas. Reg. sec. 1.1012-1(c)(1).

[223] Treas. Reg. sec. 1.1012-1(c).

[224] Treas. Reg. sec. 1.1012-1(e).

[225] Sec. 6041(a).

[226] Sec. 6045(a).

[227] Sec. 6045(b).

[228] Sec. 6721.

$100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.[229]

Present law does not require information reporting with respect to a taxpayer's basis in property but does impose an obligation to keep records, as described below.

Basis recordkeeping requirements

Taxpayers are required to "keep such records . . . as the Secretary may from time to time prescribe."[230] Treasury regulations impose recordkeeping requirements on any person required to file information returns.[231]

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.[232] IRS Publication 552 states that taxpayers "should keep" basis records for their homes. The same IRS publication states that basis records should be kept until the period of limitations expires for the year in which the taxpayer disposes of the property. There is no explicit requirement under present law that a taxpayer keep records of basis in purchased securities. A taxpayer's failure to keep adequate records may, however, preclude the taxpayer from claiming a deduction, loss, or other benefit that records might substantiate.[233]

Description of Proposal

The proposal requires certain brokers (including brokerage houses, mutual funds, asset managers, and fiduciaries) to report information regarding adjusted basis in connection with the sale of certain securities. Under the proposal, the IRS and Treasury Department are given regulatory authority to provide specific rules to implement this general basis reporting requirement, including the authority to determine the types of securities to which it will apply. Brokers also are required to report acquisition or disposition dates for securities sold so that gains and losses can be separated into short-term and long-term groups.

If a customer transfers securities from an account with one broker to an account with another, the transferor broker is required to provide basis and other relevant information to the transferee broker.

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[229] Sec. 6722.

[230] Sec. 6001.

[231] Treas. Reg. sec. 1.6001-1(a).

[232] Treas. Reg. sec. 1.1015-1(g).

[233] *See, e.g.*, *Schooler v. Commissioner*, 68 T.C. 867 (1977) (failure to substantiate alleged gambling losses).

The proposal contemplates that, under regulations, a broker will not be penalized for failing accurately to report items of information that the broker is unable to obtain with reasonable efforts. Regulations may establish a regime under which customers provide their brokers information about transactions that create basis adjustments and about the customers' initial basis in securities when brokers have no other way of knowing that information. Information about basis adjustments that are applicable to all holders of a particular class of securities of an issuer will be made available to brokers either directly by the issuer or indirectly through a central repository.

Effective date.–The proposal is effective for securities acquired after December 31, 2009.

Analysis

The intent of the proposal is to decrease misreporting of gains and losses from securities sales. The proposal is based on findings that third-party reporting increases compliance.[234] Under present law brokers must report to their customers and to the IRS the gross proceeds from customers' securities sales but are not required to report to customers or to the IRS their customers' adjusted basis in securities sold. Consequently, the information that brokers report to customers and the IRS is not sufficient for calculating gains or losses from securities sales. The proposal's basis reporting requirement is designed to provide the IRS the additional information necessary to compute those gains and losses and therefore should decrease misreporting.

The proposal may reduce taxpayers' compliance burdens. Under present law taxpayers must determine the effects of certain actions undertaken by issuers of securities -- spin-offs, recapitalizations, mergers, and return of capital distributions, for example -- on the taxpayers' basis in those securities. When corporate actions affect taxpayers' basis in securities, basis adjustment calculations may be complicated. The proposal should relieve some taxpayers from having to make these calculations because brokers would have to make the adjustments in order to provide basis information to customers in connection with securities sales. (The proposal does not, however, eliminate the general requirement to keep records necessary to determine tax liability.) Many large brokerage firms already provide this basis information as a courtesy even though they are not required by law to do so. By requiring brokers to provide the same basis information to the IRS as they provide to customers, however, the proposal may reduce or help resolve disputes between the IRS and taxpayers.

The proposal will create new burdens for some brokers. First, not all brokers now provide basis information to customers. Second, even brokers that do provide basis information may disclaim the accuracy of the information because, for example, the brokers do not record the effects on basis of certain transactions such as wash sales subject to section 1091 and return of capital distributions. Under the proposal brokers are required to provide accurate information,

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[234] See, for example, Internal Revenue Service, IRS Updates Tax Gap Estimates, IR-2006-28, Feb. 14, 2006 (finding, among other things, that the net misreporting percentages for individual capital gains and for nonfarm individual proprietor income, two categories for which there is little mandatory third-party reporting, were, respectively, 12 percent and 57 percent in 2001, whereas the net misreporting percentage for wages, salaries, and tips, for which there is reporting by employers, was one percent).

although they will not be penalized for failing to report accurately items of information they are not able to obtain with reasonable efforts. Third, the proposal requires reporting by a transferor broker when a taxpayer transfers securities from an account with one broker to an account with another broker and by the issuer of a security when issuer actions affect basis. (Many brokers, however, use a service, the Cost-Basis Reporting Service ("CBRS"), offered by the Depository Trust & Clearing Corporation ("DTCC") for transferring basis information between brokers when securities are transferred from one broker to another.[235]) This broker and issuer reporting will entail additional costs. On the other hand, although the proposal will increase burdens for some brokers, brokers may achieve economies of scale by spreading across all customer accounts the costs of calculating and tracking basis, and brokers generally can be expected to be more sophisticated in financial calculations and record-keeping than individual taxpayers.

The proposal also will present administrative challenges for the IRS. The IRS may need to modify reporting forms or create new forms. The IRS also will be required to store and make use of large volumes of new data that it will receive from brokers. To the extent the IRS is unable to manage this new data in a way that allows matching information provided by brokers with amounts reported by taxpayers on their tax returns, the enforcement gains from the proposal may be reduced.[236]

The proposal may cause taxpayers to shift their investments to instruments not subject to the basis reporting requirement. Non-tax considerations may, however, limit distortions. For example, in some cases there may be no close substitutes for the otherwise desired instruments. Possible investment distortions must be weighed against benefits of the proposal. Moreover, the likelihood of distortions will depend in part on the breadth of the rules ultimately provided in Treasury regulations defining the types of securities that are subject to the proposal.

The proposal does not describe penalties for failure to comply with new basis reporting requirements. It is unclear whether present law reporting penalties are extended to failures to comply with the proposal. If new or existing penalties do not apply, the proposal may have a lesser effect on capital gain misreporting than it would have if penalties did apply. Moreover, rules exempting brokers from penalties for failures to report information they are unable to obtain with reasonable efforts may be difficult for the IRS to administer: brokers and the IRS may disagree in particular cases about whether information is reasonably obtainable.

The proposal provides few details about which taxpayers and securities would be subject to reporting requirements. For example, which securities are subject to the proposal is left to

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[235] DTCC began offering CBRS in early 2003 to firms using its Automated Customer Account Transfer Service ("ACATS"). The majority of brokerage firms use ACATS, and the response to CBRS has been "enthusiastic." Edilyn Meringolo, "Cost-Basis Information: The Bane of the Broker's Existence," Registered Rep Magazine (March 1, 2005).

[236] A 2006 report by the Government Accountability Office ("GAO") discusses IRS data management issues. See GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603, June 2006, at 27-32.

regulations, and it is unclear whether the basis reporting requirement will apply to brokers required to report gross proceeds under section 6045 or to taxpayers who are brokers according to another definition. Because the proposal gives the Treasury Department broad authority to provide guidance implementing a general basis reporting requirement, the extent of the decrease in misreporting will depend in part on the nature of any regulations. Broad exceptions for certain classes of securities, for example, would reduce the proposal's aggregate effect on misreporting.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposals. Bills that impose basis reporting requirements (or that include provisions requiring basis reporting) have been introduced most recently in the 110th Congress.[237]

3. Require information reporting on merchant payment card reimbursements

Present Law

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[238] Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN").

Description of Proposal

The proposal requires an institution making payment to a merchant for a payment card (i.e., a credit card or debit card) transaction to report annually to the IRS the net amount paid to such merchant in a calendar year. The proposal defines the reporting institution as the bank or central organization to which the merchant sends payment card transactions for actual payment.

Under the proposal, the Secretary is authorized to provide exceptions from the reporting requirement where the benefit of improved compliance from information reporting is outweighed by the cost of compliance and where the new reporting requirement may result in duplicate reporting of certain income items.

Under the proposal, payments subject to payment card information reporting are not subject to backup withholding requirements if the paying institution has validated the merchant's TIN in a manner prescribed by the Secretary.

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[237] S. 601 (introduced by Sen. Bayh); H.R. 878 (introduced by Rep. Emanuel); H.R. 3970, section 1221(introduced by Rep. Rangel); H.R. 3996, section 622.

[238] Sec. 6041(a).

Effective date.−The proposal is effective for payments made on or after January 1, 2009.

Analysis

Requiring banks and other institutions to report annually to the IRS the aggregate reimbursement payments made to merchants could be expected to improve compliance and IRS enforcement efforts. Income that is subject to information reporting is less likely to be underreported by taxpayers. In contrast, the absence of information reporting or withholding on many types of payments results in underreporting of the related income and contributes to the tax gap.[239] In general, the more payments to which information reporting and/or withholding applies, the greater the improvement in compliance. While some consider it inappropriate to single out payment card transactions for additional information reporting, others respond that reporting is appropriate in this instance because of the large amount of income derived by businesses from payment card transactions and because the unreported income of businesses represents a significant part of the tax gap.[240]

Although the proposal can be expected to improve tax compliance, the extent of the improvement will depend on the scope of the reporting requirement after implementation. Under the proposal, the Secretary has broad authority to provide exceptions from the reporting requirement where the benefit of improved compliance from information reporting is outweighed by the cost of compliance. However, the proposal does not specify how this cost-benefit analysis will be conducted. Therefore, it is difficult to determine the breadth of potential exceptions from the reporting requirement. Similar issues regarding the scope of the proposal arise due to the lack of a definition of the term "merchant." For example, it is not clear if the proposal applies to service providers that accept payment cards, as well as to retail businesses. Clarification of the scope of transactions subject to the proposal is necessary to fully assess the potential compliance benefits.

Another issue related to the scope of the proposal is the extent to which it may overlap with other information reporting requirements. If multiple parties were to report the same transaction, the value of the reported information to the IRS would decrease and the likelihood of taxpayer errors would increase. Thus, the proposal provides Treasury with authority to establish rules preventing duplicate reporting. The compliance benefits to be realized from the proposal will depend on the extent to which overlapping information reporting is minimized through unified reporting rules established by the Secretary. The expected compliance benefits will increase to the extent such unified reporting rules require information from the entity that can provide the most accurate information.

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[239] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely.

[240] For example, for the 2001 tax year, the IRS estimates that unreported business income accounts for approximately 55 percent of the tax gap attributable to individual taxpayers. Internal Revenue Service, *IRS Updates Tax Gap Estimates*, IR-2006-28, Feb. 14, 2006.

Imposing additional information reporting also will impose costs on the private sector. Specifically, the proposal will increase the recordkeeping and reporting burdens on those organizations required to report payment card transactions. Some argue that it is unfair to burden these organizations with additional costs in order to prevent underreporting by their customers, i.e., the business taxpayers that accept payment cards. Others respond that the tax administration benefits that can be expected from the proposal justify imposing some additional costs on third parties. Moreover, proponents argue that the information that must be reported under the proposal is similar to the data provided to businesses that accept payment cards under current procedures. Therefore, any additional burden will be lessened to the extent that the reporting entities (i.e., merchant acquiring banks and other organizations) have existing procedures and systems to generate and report the data required under the proposal. Finally, the extent to which the reporting entities will actually bear the reporting costs is not clear. It can be expected that some portion of the increased costs will be borne by the businesses that accept payment cards (in the form of higher fees paid to the merchant acquiring banks). In the long run, some portion of these costs also may be borne by consumers who use payment cards for purchases.

Prior Action

A similar proposal was included in the President's fiscal year 2007 and 2008 budget proposals.

4. Require a certified taxpayer identification number from contractors

Present Law

Information reporting

A taxpayer identification number (TIN) is an identification number used by the IRS for purposes of tax administration. A TIN must be furnished on all returns, statements, or other tax related documents.

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business to a person that is not a corporation. Special information reporting requirements exist for employers that are required to deduct and withhold tax from employees' income.

Government entities are specifically required to make an information return, reporting certain payments to corporations as well as individuals. Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).

The Code provides that a person (the payor) required to make a return with respect to another person (the payee) must ask the payee for the identifying number prescribed for securing the proper identification of the payee and include that number in the return. Typically, if there is an error in the name/TIN combination furnished by the payee, the IRS may disclose such error to the payor is permitted only at the point when the payment is subject to backup withholding under section 3406.

Withholding

Many payments are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors). Since contractors are not subject to withholding, they may be required to make quarterly payments of estimated income taxes and self-employment taxes. The contractor is required to pay any balance due when the annual income tax return is subsequently filed.

Description of Proposal

Certified TINs

Under the proposal, a contractor receiving payments of $600 or more in a calendar year from a particular business is required to furnish to the business the contractor's certified TIN. A business is required to verify the contractor's TIN with the IRS, which is authorized to disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records. It is understood that the IRS will not provide the correct TIN in response to an incorrect TIN submission; it will state only that the information does not match IRS records.

Withholding

If a contractor fails to furnish an accurate certified TIN, the business (payor) is required to withhold a flat rate percentage of gross payments.

Contractors receiving payments of $600 or more in a calendar year from a particular business could require the business to withhold a flat rate percentage of their gross payments, with the flat rate percentage of 15, 25, 30 or 35 percent being selected by the contractor.

Effective date

The proposal is effective for payments made to contractors on or after January 1, 2009.

Analysis

The IRS receives a significant number of information returns each year containing missing or incorrect name and TIN information. In general, the compliance rate is high when there is both information reporting and withholding. For example, the rate of misreporting of

wages and salaries is 1.2 percent.[241] The IRS has indicated that amounts subject to third-party information reporting but not withholding have a higher misreporting percentage. For example, the misreporting rate for interest and dividends is 4.5 percent.[242] Amounts generally subject to neither withholding nor third party information reporting, such as sole proprietor income and "other income," are the most likely to be misreported. The IRS has indicated that the net misreporting percentage for this group of items is 53.9 percent.[243]

In light of these statistics, some argue that compliance will be enhanced if payors have the ability to verify payee TINs with the IRS prior to filing information returns for reportable payments on behalf of such payees. Because the proposal requires withholding on gross proceeds, rather than taxable income, the proposal may result in excess withholding on payments for which an accurate certified TIN is not provided. On the other hand, the IRS will have in hand the amounts withheld in the event that the contractor failing to supply the TIN also fails to report the income.

Some might argue that to the extent a contractor is a sole proprietor whose TIN is also his social security number ("SSN"), the contractor may have concerns, such as identity theft, in supplying the SSN to third parties. In the case of a tax-compliant taxpayer, the failure to supply a TIN may result in unnecessary withholding and cause hardship resulting from the decreased cash flow. On the other hand, the fact that income from sole proprietorships is among the most likely categories of income to be misreported may justify placing an additional burden on the compliant, as well as noncompliant to ensure that taxes due and owing are paid.

Some may argue that giving a contractor the option to impose withholding requirements at varying rates on a business payor that might not otherwise engage in such withholding may impose an administrative paperwork and remittance burden on the payor to the extent it is a unilateral decision. On the other hand, the compliance burden on the contractor might be reduced as funds would be set aside to meet their tax obligations.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposal.

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[241] Mark Everson, Commissioner of Internal Revenue, *Written Testimony of Commissioner of Internal Revenue Mark Everson before the Senate Committee on the Budget on the FY 2008 IRS Budget and the Tax Gap* (February 14, 2007) at 15.

[242] *Id.*

[243] *Id.*

5. Increased information reporting for certain government payments for property and services

Present Law

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[244] Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN"). Special information reporting requirements exist for employers required to deduct and withhold tax from employees' income.[245] In addition, any service recipient engaged in a trade or business and paying for services is required to make a return pursuant to regulations when the aggregate amount of such payments is $600 or more.[246]

Government entities also are required to make an information return, reporting certain payments to corporations as well as individuals.[247] Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).[248]

Effective for payments made after December 31, 2010, section 511 of the Tax Increase Prevention and Reconciliation Act of 2005[249] ("TIPRA") imposes new withholding requirements on certain government payments. Specifically, the provision imposes a three percent withholding rate on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for property or services that would otherwise be subject

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[244] Sec. 6041(a).

[245] Sec. 6051(a).

[246] Sec. 6041A.

[247] Sec. 6041A(d)(3)(A).

[248] Sec. 6050M.

[249] Pub. L. No. 109-222.

to withholding under this provision are exempt from the withholding requirement. The provision imposes information reporting requirements on the payments that are subject to withholding under the provision.

Description of Proposal

The proposal provides the Secretary with authority to promulgate regulations requiring information reporting on all non-wage payments by Federal, state and local governments to procure property and services. Under the proposal, the Secretary is expected to exclude certain categories of payments from the information reporting and backup 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.

Effective date.−The proposal is effective for payments made by Federal, State and local governments on or after January 1, 2009.

Analysis

The proposal could enhance compliance with the tax laws by requiring additional information reporting on certain non-wage payments. However, the extent to which the proposal improves compliance will depend on the scope of payments subject to the proposal and any exceptions. For example, under present law, government entities are required to report payments to a service provider when the aggregate of payments to such service provider is $600 or more. The proposal does not specify whether a similar dollar threshold would apply to payments subject to the reporting requirements. Because the extent to which the proposal expands upon present-law requirements is unclear, it is difficult to fully assess the relative benefits and burdens associated with the proposal.

In addition, payments subject to the proposal are the same type of payments subject to the withholding provision enacted in TIPRA, which applies to payments made after December 31, 2010. The withholding provision in TIPRA can be expected to have a greater impact on compliance than information reporting alone.

Imposing additional information reporting requirements also will impose new costs on payors. The requirements will increase the recordkeeping and reporting burdens on payors subject to the proposal. Proponents respond that, in many cases, the affected parties already have procedures in place that can be modified to accommodate the additional requirements. For example, present law imposes information reporting requirements on governmental entities. Arguably, the proposal will require only the expansion of existing procedures to satisfy the broader requirements under the proposal, not the creation of wholly new procedures. Similarly, certain Federal payments to vendors of goods or services are subject to continuous levy authority under present law.[250] Thus, government entities are likely to have existing systems and procedures for deducting and remitting taxes from payments to businesses and individuals that

[250] Sec. 6331(h).

may be tailored to the specific requirements of the proposal. Moreover, to the extent the proposal requires new procedures, such procedures are likely to be similar to those necessary to comply with the withholding provision enacted in TIPRA.

Finally, some consider it inappropriate to single out payments by Federal, state and local governments for additional information reporting, rather than expanding reporting requirements more generally. Others respond that additional information reporting is appropriate in this instance due to concerns regarding noncompliance by government contractors.[251]

Prior Action

A similar proposal was included in the President's fiscal year 2007 and 2008 budget proposals.

6. Increase information return penalties

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721 of the Code, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $100, with no calendar year limit.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 of the Code also imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with

[251] U.S. Government Accountability Office, *Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence*, GAO-05-637, June 2005.

other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Description of Proposal

The proposal increases the first tier penalty from $15 to $30, and increases the calendar year maximum from $75,000 to $250,000. The second tier penalty is increased from $30 to $60, and the calendar year maximum is increased from $150,000 to $500,000. The third tier penalty is increased from $50 to $100, and the calendar year maximum is increased from $250,000 to $1,500,000. For small business filers, the calendar year maximum is increased from $25,000 to $75,000 for the first tier penalty, from $50,000 to $200,000 for the second-tier penalty, and from $100,000 to $500,000 for the third tier penalty. The minimum penalty for each failure due to intentional disregard is increased from $100 to $250.

Effective date.−The proposal is effective for information returns required to be filed on or after January 1, 2009.

Analysis

Penalties for the failure to comply with tax laws are necessary if broad compliance with the tax laws is to be expected. Penalties serve to establish and validate the standards of behavior set forth by the tax laws themselves, as well as to punish specific departures from such laws. In the absence of penalties, the tax laws would, at best, represent a suggested code of behavior.

Ideally, tax penalties would be set to achieve the following goals: (1) encourage voluntary compliance, (2) operate fairly, (3) deter undesired behavior, and (4) promote efficient and effective administration of the provisions by the IRS. The information return penalties, in particular, are designed to encourage persons to file correct information returns, even when such returns are filed after the prescribed filing date. Thus, there is a three-tier structure to present-law information return penalties in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure.

Proponents of the proposal argue that the information return penalties have not been increased in many years and, as a result, the penalties are too low to discourage non-compliance. For example, the present law caps on information reporting penalties may make it less costly for entities filing large numbers of information returns to incur the maximum penalty than to conduct internal audits to verify the accuracy of filed information returns. Proponents argue that increasing the information return penalties and the cap on such penalties will encourage the filing of timely and accurate information returns, which will improve overall tax administration.[252] Most research shows that taxpayer compliance rises with the level of penalties combined with the probability of audit. Thus, the proposal could be expected to increase compliance to the extent there is not a corresponding decrease in the audit of information returns.

[252] For example, research shows that underreported income accounts for the largest portion of the tax gap. Internal Revenue Service, *IRS Updates Tax Gap Estimates*, IR-2006-28, Feb. 14, 2006.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposals. A similar provision was included in H.R. 3997, as passed by the House of Representatives on December 18, 2007.

7. Improve the foreign trust reporting penalty

Present Law

Section 6048 of the Code requires certain persons to report information to the IRS with respect to foreign trusts. A grantor or other person transferring assets to a foreign trust must report the transfer and the identity of the trust and of each trustee and beneficiary of the trust. A U.S. person that receives a distribution from the trust must report the distribution. A U.S. owner of any portion of a foreign trust is responsible for ensuring that the trust files an information return for the year. In the case of transfers to, or distributions from, a foreign trust, reporting is accomplished by filing Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Gifts. A foreign trust with a U.S. owner files a Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner.

The Code imposes a penalty on any person responsible for filing Form 3520 or Form 3520-A if the applicable form is not filed timely or it is incomplete or incorrect.[253] In the case of persons required to file Form 3520, the penalty is equal to 35 percent of the "gross reportable amount." In the case of a U.S. owner of a foreign trust, the penalty is equal to five percent of the "gross reportable amount." In general, the gross reportable amount is the gross value of property transferred to the trust, the gross value of the portion of the trust's assets at the close of the year that is treated as owned by a U.S. person, or the gross amount of distributions received from the trust. In the case of any failure to report that continues for more than 90 days after the IRS mails notice of such failure, an additional penalty of $10,000 applies for each 30-day period (or fraction thereof) during which the failure continues. The total penalties with respect to any failure may not exceed the gross reportable amount.

Description of Proposal

The penalty provision would be amended to impose an initial penalty equal to the greater of $10,000 or 35 percent (five percent in the case of U.S. owners) of the gross reportable amount (if the gross reportable amount is known). The additional $10,000 penalty for continued failure to report remains unchanged. Thus, even if the gross reportable amount is not known, the IRS may impose a $10,000 penalty on a person who fails to report timely or correctly as required and may impose a $10,000 penalty for each 30-day period (or fraction thereof) that the failure to report continues.

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[253] Sec. 6677.

The total penalties are capped at the gross reportable amount as under current law. If a person provides enough information for the IRS to determine the gross reportable amount, any excess penalty already paid would be refunded.

Effective date.–The proposal is effective for information reports required to be filed on or after January 1, 2009.

Analysis

Reporting requirements assist taxpayers in complying with the U.S. tax laws and the IRS in determining whether taxpayers' returns are correct and complete. Penalties for failure to comply with reporting requirements create an incentive to comply with the reporting requirements by increasing the expected costs of noncompliance.

Certain persons, such as U.S individuals who are concealing income or possibly engaged in some criminal activity, are currently not complying with the foreign trust reporting requirements. In addition, there are certain persons who structure transactions in a manner that avoids the reporting requirements.[254]

A third-party may provide the IRS with information that certain persons are not complying with the foreign trust reporting requirements. In such cases, although the IRS may be aware of noncompliance by a particular person, the IRS may not have sufficient information to determine the gross reportable amount and calculate the appropriate penalties. This makes imposition of the penalties problematic and impedes the ability of the IRS to enforce the reporting requirements and related trust provisions.[255] By ensuring that the IRS can assess penalties, notwithstanding a gap in its available information, the proposal will assist the IRS in its enforcement of the reporting requirements and related foreign trust provisions.

More generally, by increasing the expected cost of failing to comply with the foreign trust reporting requirements, the proposal can be expected to increase compliance by those persons who are required to report, but who choose not to based on the belief that detection is unlikely. The proposal is not expected to affect the behavior of those who successfully structure

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[254] Staff of the Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*, August 3, 2006 at 26 (released by Senate Finance Committee on October 19, 2006 and available on Senate Finance Committee website at http://finance.senate.gov/press/Gpress/2005/prg101906.pdf) (the "JCT Compliance Report"); *see also* Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, *Tax Haven Abuses: The Enablers, the Tools and Secrecy*, August 1, 2006 (providing a detailed description of several strategies utilizing foreign trusts and other offshore entities in tax havens to avoid U.S. tax).

[255] *See* Sec. 7491(c) (providing that Secretary has the burden of production in any court proceeding with respect to the liability of any individual for any penalty).

a transaction to avoid the reporting requirements. In addition, the proposal may not affect the behavior of certain persons, such as those engaging in criminal activity.[256]

Prior Action

No prior action.

[256] JCT Compliance Report at 27.

B. Improve Compliance by Businesses

1. Require e-filing by certain large organizations

Present Law

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[257] states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

Present law authorizes the IRS to issue regulations specifying which returns must be filed electronically.[258] There are several limitations on this authority. First, it can only apply to persons required to file at least 250 returns during the year.[259] Second, the IRS is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may be filed electronically by choice).

The IRS requires corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. Private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns for tax years ending on or after December 31, 2006, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer.

Effective for tax years ending on or after December 31, 2004, the IRS requires corporations with total assets in excess of $10 million to file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 million or More). Effective for tax years ending on or after December 31, 2006, the Schedule M-3 filing requirement also applies to the following entities with assets in excess of $10 million: S corporations; life insurance corporations; property and casualty insurance corporations; cooperative associations; and partnerships.

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[257] Pub. L. No. 105-206 (1998).

[258] Sec. 6011(e).

[259] Partnerships with more than 100 partners are required to file electronically. Sec. 6011(e)(2).

Description of Proposal

The proposal requires all corporations and partnerships required to file Schedule M-3 to file income tax returns electronically. In the case of certain taxpayers not required to file Schedule M-3 (such as exempt organizations), the proposal provides the Secretary authority to require electronic filing without regard to the present-law 250 return minimum. The proposal requires the Secretary to balance the benefits of electronic filing against any burden that might accrue to taxpayers. Implementation of the proposal is to take place incrementally to afford adequate time for transition to electronic filing. The Secretary is permitted to provide waivers to taxpayers who cannot meet the electronic filing requirement due to technology constraints, undue financial burden, or other reasons specified in regulations.

Effective date.−The proposal is effective for tax years ending after December 31, 2008.

Analysis

RRA 1998 set a goal for the IRS to have 80 percent of tax returns filed electronically by 2007. However, growth in electronic filing is slowing and the IRS has reported that the goal set by Congress will not be achieved. Expanding the scope of returns that are required to be filed electronically may be viewed as helping the IRS to meet the 80 percent goal set by the Congress.

Electronic filing produces a number of benefits both for taxpayers and the IRS, including shorter processing times, fewer errors, and better data. Proponents argue that the efficiencies and cost savings achieved through electronic filing justify expanding such requirements. For example, the Government Accountability Office has reported that electronic filing has enabled the IRS to close two paper processing centers, and saved 1600 staff years.[260]

On the other hand, opponents argue that expanding electronic filing mandates will impose additional costs on taxpayers who will be required to submit tax returns and related schedules in a format that can be processed by the IRS. In addition, even if taxpayers have the necessary systems to meet expanded electronic filing requirements, the expected benefits from the proposal only will be realized to the extent the IRS has sufficient resources to effectively analyze the transmitted data. Proponents respond that electronic filing yields significant tax administration benefits and, with the widespread adoption of computer technology, represents a minimal burden to taxpayers.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, and 2008 budget proposals.

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[260] Government Accountability Office, GAO-07-27, Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings (November 2006).

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

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[261]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($102,000 for 2008). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

Under FUTA, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions means payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.[262]

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Wages paid to employees, and FICA and income taxes withheld from the wages, are required to be reported on employment tax returns and on Form W-2.[263]

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[261] Secs. 3101-3128 (FICA), 3201-3241 (the Railroad Retirement Tax Act), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[262] The "SUTA Dumping Prevention Act of 2004" (Pub. L. No. 108-295), set standards for State law to prevent the practice of "SUTA dumping," a tax evasion scheme where shell companies are formed to obtain low State unemployment insurance tax rates.

[263] Secs. 6011 and 6051.

Responsibility for employment tax compliance

Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[264] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether an employer-employee relationship exists is often relevant in determining whether a worker is an employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.[265]

In some cases, a person other than the common-law employer may be liable for employment taxes. For example, if wages are paid to an employee by a person other than the employer and the payor, rather than the employer, has control of the payment of the wages, the payor is responsible for complying with the applicable employment tax requirements.[266] In addition, certain designated agents are jointly and severally liable with the employer for FICA tax and income tax withholding with respect to wages paid to the employer's employees.[267]

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[264] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

[265] Issues relating to the classification of workers as employees or independent contractors are discussed in Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), May 2007. These issues are also discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, at Vol. II, Part XV.A, at 539-550.

[266] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); and *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. U.S.*, 38 Fed. Cl. 450 (1997), and *Winstead v. U.S.*, 109 F. 3d 989 (4th Cir. 1997).

[267] Sec. 3504. The designated payroll agent rules do not apply for FUTA purposes.

These designated agents prepare and file employment tax returns using their own names and employer identification numbers.[268] 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 arrangements

An employee leasing company (sometimes called a professional employer organization) provides employees to perform services in the businesses of the employee leasing company's clients, generally small and medium-sized businesses. In many cases, before the employee leasing arrangement is entered into, the employees already work in the client's business as employees of the client. The terms of a typical employee leasing agreement provide that the employee leasing company is responsible for paying the employees and for the related employment tax compliance. Legally, the employees may be the employees of the client, rather than the employee leasing company; nonetheless, clients typically rely on the employee leasing company to satisfy employment tax obligations.[269]

Description of Proposal

The proposal contemplates the establishment of standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes and standards for holding employee leasing companies solely liable for such taxes if they meet specified requirements. Details of the proposal have not yet been provided.

Effective date.−The proposal is effective for employment tax returns filed with respect to wages paid on or after January 1, 2009.

Analysis

In the absence of a detailed proposal, the following analysis discusses general issues relating to employee leasing companies and employment taxes.

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[268] The employer's name, address, and employer identification number, as well as the agent's, are provided when the agent is designated by the employer. Form 2678 is used to designate an agent.

[269] As discussed in the text above, the issue of whether a worker is an employee of a particular entity for employment tax purposes is generally determined by reference to the Treasury regulations under sections 3121(d), 3306(i), and 3401(c), which incorporate the common law definition of employee. This common law definition also generally applies for purposes of determining who is an employee for retirement plan purposes. In some cases, a professional employer organization may provide benefits to workers who are legally the employees of the customer. The IRS has issued guidance with respect to the application of the retirement plan rules in such cases. For example, Revenue Procedure 2002-21, 2002-1 C.B. 911, provides that employees of a customer may be covered under a multiple employer defined contribution plan of the professional employer organization if the customer adopts the plan and certain other requirements are satisfied. *See also* Rev. Proc. 2003-86, 2003-2 C.B. 1211.

In a study of the tax gap for the 2001 tax year, the IRS estimates that the portion of the gap attributable to FICA and FUTA taxes is $15 billion.[270] An additional portion of the tax gap is attributable to income taxes due on unreported wages. The proposal is aimed at improving employment tax compliance by businesses.

In an employee leasing arrangement, clients typically rely on the leasing company to comply with the applicable employment tax requirements. This is the case regardless of whether legal responsibility for employment tax compliance rests with the leasing company or with the client. In such a case, absent an audit, the IRS generally has no way of knowing whether the leasing company or the client is the employer, or even that a leasing arrangement exists. If neither the leasing company nor the client complies with the applicable employment tax requirements, it may be difficult to determine which party is liable for compliance.

Uncertainty as to who is responsible for employment tax compliance in an employee leasing arrangement may mean that, as a practical matter, no one is held responsible for the payment of employment taxes. Providing clear rules for determining who is liable for employment taxes in employee leasing arrangements would address those issues and could improve compliance. In addition, joint and several liability may make it more difficult for an employee leasing company to avoid employment tax liability with respect to wages paid to leased employees.

Some believe that leasing companies offer a greater likelihood of employment tax compliance than can be expected from clients on an individual basis, particularly in the case of clients that are small businesses.[271] On the other hand, the payroll of a leasing company typically includes the payroll for employees leased to many client businesses, as well as payroll for employees working directly for the leasing company. Accordingly, the failure of a leasing company to comply with employment tax obligations may result in noncompliance on a larger scale than the level of noncompliance that would otherwise occur among client businesses. Rules for holding leasing companies solely liable for employment taxes should therefore include adequate standards and procedural safeguards to assure that the leasing company will in fact comply. Some argue that existing rules, such as the designated agent rules, are sufficient to permit leasing companies to assume employment tax responsibility and thus there is no need for special rules (such as the proposal) under which only the leasing company is liable for a failure to pay employment taxes.

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[270] IRS news release IR-2006-28 and attachment (Feb. 14, 2006). The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely.

[271] Such proponents observe that an employee leasing company should have an expertise in the proper handling of employee wages since the payment of wages is a core business function of such a company. Apart from employment tax compliance benefits, proponents of employee leasing companies note that economies of scale permit leasing companies to provide their leased employees with benefits that cannot be provided on an affordable basis by their smaller clients.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposal.

C. Strengthen Tax Administration

1. Allow Internal Revenue Service ("IRS") to access information in the National Directory of New Hires ("NDNH")

Present 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 and verifying a taxpayer's employment that is reported on a tax return.

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

Description of Proposal

The proposal amends the Social Security Act 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 under the proposal is subject to the confidentiality and disclosure rules applicable to taxpayer information.

Effective date.–The proposal is effective upon enactment.

Analysis

The proposal could enhance tax administration by providing the IRS with a more efficient method to obtain taxpayer data. Obtaining taxpayer data from a centralized source such as the NDNH, rather than from separate State agencies, should increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing such data. Some may argue that allowing the IRS to access the NDNH for general tax administration purposes infringes on individual privacy and extends the use of the database beyond that which was originally intended, to enable state child support enforcement agencies to be more effective in locating noncustodial parents. On the other hand, data obtained by the IRS from the NDNH is protected by existing disclosure law. Thus, the proposal does not reduce the current levels of taxpayer privacy.

Prior Action

An identical proposal was included in the President's fiscal year 2006, 2007, and 2008 budget proposals.

2. Permit disclosure of prison tax scams

Present Law

Section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Code.[272] A "return" is any tax or information return, declaration of estimated tax, or claim for refund required by, or permitted under, the Code, that is filed with the Secretary by, on behalf of, or with respect to any person.[273] "Return" also includes any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed.

The definition of "return information" is very broad and includes any information gathered by the IRS with respect to a person's liability or possible liability under the Code.[274] However, data in a form that cannot be associated with, or otherwise identify, directly or indirectly a particular taxpayer is not "return information" for section 6103 purposes.

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[272] Sec. 6103(a).

[273] Sec. 6103(b)(1).

[274] Sec. 6103(b)(2). Return information is:

- a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense,

- any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110,

- any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to such agreement or any application for an advance pricing agreement, and

- any closing agreement under section 7121, and any similar agreement, and any background information related to such an agreement or request for such an agreement

Section 6103 contains a number of exceptions to the general rule of confidentiality, which permit disclosure in specifically identified circumstances when certain conditions are satisfied.[275] None of the exceptions permit the IRS to refer the tax-related misconduct of specific inmates to prison officials for imposition of administrative sanctions against such individuals. The IRS does publicize information from prosecutions which has been made part of the public record of such proceedings.

Description of Proposal

The IRS is authorized to disclose certain limited return information about tax violations identified by the IRS to Federal prison officials, so that prison officials could punish and deter such conduct through administrative sanctions. The safeguard provisions as well as criminal sanctions would apply.

Effective date.–The proposal is effective for disclosures made on or after January 1, 2009.

Analysis

In 2004, the IRS identified 18,000 false prisoner returns claiming $68 million in refunds. The IRS was able to stop the issuance of 78 percent of these refunds.[276]

The schemes ranged from false wage and self-employment reports to complex transactions involving outside co-conspirators, stolen identities, and sophisticated financial transactions to disguise the true source of funds. Such schemes included filing false forms, including Form W-2, Schedule C, and Form 1099. Erroneous credits claimed included the earned income tax credit ("EIC") and Advance EIC, the child and dependent care credit, the child tax credit and the adoption credit.[277]

In an effort to prevent prisoner refund fraud, the IRS has stated that it has developed a close working relationship with many States and prison officials. The IRS conducts outreach meetings with prison officials on the local and national level to discuss the types of schemes the

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[275] Sec. 6103(c) - (o). Such exceptions include disclosures by consent of the taxpayer, disclosures to State tax officials, disclosures to the taxpayer and persons having a material interest, disclosures to Committees of Congress, disclosures to the President, disclosures to Federal employees for tax administration purposes, disclosures to Federal employees for nontax criminal law enforcement purposes and to the Government Accountability Office, disclosures for statistical purposes, disclosures for miscellaneous tax administration purposes, disclosures for purposes other than tax administration, disclosures of taxpayer identity information, disclosures to tax administration contractors and disclosures with respect to wagering excise taxes.

[276] Statement of Nancy J. Jardini, Chief, Criminal Investigation, Internal Revenue Service, Testimony before the Subcommittee on Oversight of the House Committee on Ways and Means (June 29, 2005).

[277] *Id.*

IRS is seeing within their institutions. In some instances, tax forms have been removed from prison libraries and some States have declared tax materials found in prison cells to be contraband. Seventy-eight percent of all false prisoner returns filed with the IRS were paper returns.

The IRS does develop and refer prison cases for prosecution. However, due to limited resources, the IRS has focused mainly on those schemes involving persons on the outside assisting the prisoners in their schemes. According to the IRS, some U.S. Attorney's offices are reluctant to pursue prisoner investigations, believing it is not a prudent use of resources if the person is already incarcerated and another conviction would not likely yield additional punitive sanctions.[278]

The fact that a prisoner has filed what the IRS believes to be a fraudulent return is confidential return information. There is no exception in the Code for the IRS to disclose this information to allow prison officials to administratively punish the prisoner for filing a false return. Some may argue that subjecting a prisoner to administrative punishment solely on the basis of the IRS belief that the prisoner might have filed a fraudulent return raises due process concerns and questions about the level of proof necessary before administrative punishment should be imposed. Others argue that such information is not unlike any other "tip" a prison might receive about a prisoner's misconduct and that the prison would be required to do whatever necessary investigation on its own prior to imposing any administrative sanctions. Further, proponents argue that when a person is already incarcerated and an additional conviction is not likely to have a deterrent effect, taking away a prisoner's privileges might be an effective method of stopping repeat offenders.

As noted above, the IRS does conduct outreach efforts with prisons to make them aware of schemes within their facilities, so that they can take corrective action. The IRS can provide aggregate information and data in a form that does not identify directly or indirectly a particular taxpayer to make prisons aware of the existence of problems within their facilities. The IRS notes that such efforts have been successful, and therefore, some might question the need for additional authority for prison administration purposes.

Others might argue that the IRS focus should be on improving the tools for detecting fraudulent refunds, rather than after-the-fact punishment. For example, each year the IRS requests the Federal Bureau of Prisons, the 50 States and the District of Columbia for a list of prisoners on the rolls. That information is entered into a database and used in the tax return screening process. However, there is inconsistency in the type of data supplied and because supplying the information is not mandatory, the IRS notes it can be a low priority for the prisons.[279] Further, the IRS has determined that 20 percent of the prisoner identification

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[278] The Honorable J. Russell George, Treasury Inspector General for Tax Administration, U.S. Department of the Treasury, Testimony before the Subcommittee on Oversight of the House Committee on Ways and Means (June 29, 2005).

[279] Statement of Nancy J. Jardini, Chief, Criminal Investigation, Internal Revenue Service, Testimony before the Subcommittee on Oversight of the House Committee on Ways and Means (June 29, 2005).

information received is inaccurate. Improved information from the prisons to assist in the detection of fraudulent returns and enhanced fraud detection techniques may be more effective in preventing erroneous refunds, than the deterrent effect resulting from the punishment of individual prisoners. In addition, prisons could take steps to block online filing sites as the IRS has suggested, in addition to deeming paper returns as contraband.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposal.

3. Make repeated willful failure to file a tax return a felony

Present Law

Under present law, the willful failure to file a return, pay taxes, keep records, or supply any information required by the Code is a misdemeanor punishable by a term of imprisonment of not more than one year, a fine up to $25,000, or both. In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Description of Proposal

Under the proposal, any person who willfully fails to file tax returns for any three years within a five consecutive year period and whose aggregated tax liability for such period is at least $50,000 is subject to a new aggravated failure to file penalty. The proposal classifies an aggravated failure to file as a felony punishable by a term of imprisonment of not more than five years, a fine up to $250,000 ($500,000 in the case of a corporation), or both.

Effective date.–The proposal is effective for returns required to be filed on or after January 1, 2009.

Analysis

Some argue that existing criminal tax penalties do not adequately deter criminal behavior, which results in increased noncompliance. Generally, anything that increases the expected costs of noncompliant behavior, such as increased penalties or increased audit rates, would be expected to decrease the amount of noncompliance. Increasing the monetary penalties for failing to file a tax return increases the economic risk of such failure, assuming the likelihood of detection does not decrease.

Similarly, classifying certain willful failure to file cases as felonies should discourage criminal tax violations by substantially increasing the monetary and sentencing consequences of the offense together with the long term repercussions associated with a felony record. However, opponents argue that the proposal unnecessarily increases complexity because present law provides enhanced criminal penalties where a failure to file a tax return is accompanied by egregious behavior, such as an intent to evade taxes. Proponents respond that the filing obligation is of paramount importance to the tax system. Proponents argue that a repeated pattern of intentionally failing to file poses a serious threat to the system and warrants the creation of a separate felony crime. On the other hand, the very fact that there are long term

repercussions associated with a felony may have unintended consequences. For example, the government may exercise its discretion to assert such a penalty in fewer cases than if the offense were classified as a misdemeanor. To the extent a penalty is not applied in practice, the deterrent effects of the penalty would not be realized. Finally, to the extent the imposition of a criminal penalty may result in significant jail time, the government also must consider the costs of incarceration.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposals. Similar provisions also were included in S. 1321, the "Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006,"[280] as reported by the Senate Finance Committee, and H.R. 2, the "Small Business and Work Opportunity Act of 2007," as passed by the Senate on February 1, 2007.

4. Facilitate tax compliance with local jurisdictions

Present Law

Generally, tax returns and return information ("tax information") is confidential and may not be disclosed unless authorized in the Code. One exception to the general rule of confidentiality is the disclosure of tax information to the States.

Tax information with respect to certain taxes is open to inspection by State agencies, bodies, commissions, or its legal representatives, charged under the laws of the State with tax administration responsibilities.[281] Such inspection is permitted only to the extent necessary for State tax administration proposes. The Code requires a written request from the head of the agency, body or commission as a prerequisite for disclosure. State officials who receive this information may redisclose it to the agency's contractors but only for State tax administration purposes.[282]

The term "State" includes the 50 States, the District of Columbia, and certain territories.[283] In addition, cities with populations in excess of 250,000 that impose a tax on income or wages and with which the IRS has entered into an agreement regarding disclosure also are treated as States.[284] The term "State" does not include Indian tribal governments.

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[280] S. Rep. No. 109-336 (2006).

[281] Sec. 6103(d)(1).

[282] Sec. 6103(n).

[283] Sec. 6103(b)(5)(A).

[284] Sec. 6103(b)(5)(B).

Description of Proposal

Indian tribal governments that impose alcohol, tobacco, or fuel excise or income or wage taxes would be treated as States for purposes of information sharing to the extent necessary for Indian tribal government tax administration. An Indian tribal government that receives Federal tax information would be required to safeguard it according to prescribed protocols. Criminal and civil sanctions would apply.

Effective date.–The proposal is effective for disclosures made after the date of enactment.

Analysis

Many States use Federal tax concepts as the starting point for their own returns. As a result, those States are dependent on Federal tax information to ensure compliance with their own State tax system. In addition, cooperation between the IRS and State governments is thought to improve voluntary compliance. The IRS has recently embarked on a program to obtain more information from the States to assist with Federal tax compliance.

The proposal would expand the definition of State to include an Indian tribal government for purposes of disclosing tax information. On the one hand, providing tax information to an Indian tribal government may assist such tribe with the enforcement of tribal tax laws. The sharing of information with Indian tribal governments also may encourage the tribes to share information with the IRS that may be helpful for Federal enforcement efforts.

Unlike the rule for cities to be treated as a State, generally requiring a population of 250,000 or more, the proposal sets no minimum population requirement for an Indian tribe to be treated as a State. Some may argue that the privacy rights of taxpayers are more likely to be compromised if the population of taxpayers whose information is subject to disclosure is very small. One also could argue that the benefit to Federal tax compliance would decline as the size of the population diminishes. In addition, Federal tax data is subject to stringent physical and computer security restrictions, which may be costly and burdensome for a small tribal government to implement.

Prior Action

No prior action.

5. Extension of statute of limitations where State tax adjustment affects Federal tax liability

Present Law

In general, the Code requires that taxes be assessed within three years[285] after the date a return is filed.[286] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time.

Several important exceptions in the Code extend the statute of limitations. If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[287] If a taxpayer has engaged in a listed transaction and has failed to include on any return or statement for any taxable year any information required under section 6011 to be included with such return or statement, the statute of limitations with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary.[288] In the case of a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[289] The statute of limitations also may be extended by taxpayer consent.[290]

In general, the statute of limitations with respect to claims for refund expires three years from the time the return was filed or two years from the time the tax was paid, whichever is later.

Description of Proposal

The proposal would create an exception to the general three-year statute of limitations on assessment. In the case of a Federal tax liability resulting from adjustments to State or local tax liability, the statute of limitations would be extended to the greater of: (1) one year from the date the taxpayer files an amended return with the IRS reflecting adjustments to the State or local tax return, or (2) two years from the date the IRS receives information from the State or local revenue agency under an information sharing agreement. The statute of limitations would be

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[285] Sec. 6501(a).

[286] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[287] Sec. 6501(e).

[288] Sec. 6501(c)(10).

[289] Sec. 6501(c).

[290] Sec. 6501(c)(4).

extended only with respect to the increase in Federal tax attributable to the State or local tax adjustment.

The statute of limitations on claims for refund would be extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the State or local examination report will take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

Effective date.–The proposal is effective for returns required to be filed after December 31, 2008.

Analysis

Congress has regarded it as "ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensible element of fairness as well as of practical administration of an income tax policy."[291]

There are a number of exceptions to the general three-year statute of limitations, many of which are premised on the theory that the statute of limitations should not run when the taxpayer has not disclosed facts that allow the IRS to make an accurate assessment. For example, there is no statute of limitations in the case of a false or fraudulent return. In that case, the taxpayer who has filed a fraudulent return with intent to evade tax hardly is in a position to complain of the fairness of a rule that facilitates the IRS's collection of the tax due. Similarly, where a taxpayer has omitted substantial items of income, the IRS is provided with an additional three years to make an assessment.

The proposal would extend the statute of limitations in cases where adjustments to State or local taxes create an additional Federal tax liability. Proponents argue an extension is appropriate in such cases because the IRS is often unaware of a State or local adjustment affecting Federal tax liability until the general three-year statute of limitations has expired. The taxpayer, it is argued, is on notice of the State or local revenue agency proceeding that may result in a Federal tax liability and, thus, should not avoid collection simply by concealing the State or local proceeding and determination from the IRS.

Opponents of the proposal may argue that the mere fact of a State or local revenue agency determination is distinguishable from other situations where the statute of limitations is extended, such as where the taxpayer has failed to disclose information on a tax return. A State or local tax adjustment may or may not be based on information that is available from the face of the filed tax return. In a case where the information necessary to make an adjustment is available from the face of the return (i.e., the taxpayer did not fail to disclose information), some may argue that the burden should be on the taxing agencies to share information in a manner that would allow assessments to be made in a timely manner, rather than placing the burden on the

[291] *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 300 (1946).

taxpayer to notify the IRS of a State or local determination. To address this concern, rather than providing a general exception to the statute of limitations in the case of any State or local determination affecting Federal tax liability, the proposal could be limited to those situations where the State or local determination was based on information that taxpayer failed to disclose on the filed return.

Prior Action

No prior action.

6. Improve investigative disclosure statute

Present Law

In general, returns and return information are confidential and cannot be disclosed unless an exception to this general rule applies. One exception, section 6103(k)(6) relating to investigative disclosures, permits Treasury and IRS personnel to disclose return information to the extent necessary to obtain information not otherwise reasonably available in the course of an audit or investigation as prescribed by regulation. Treasury regulations permit a revenue agent to identify himself as affiliated with the IRS and to display his credentials. An agent may also disclose the nature and subject of an investigation as necessary to obtain information from a witness in connection with that investigation.

Description of Proposal

Section 6103 would be amended to provide that Treasury and IRS officers and employees are not prohibited from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

Efffective date.–The proposal is effective for disclosures made after the date of enactment.

Analysis

The proposal would make it unnecessary for a revenue agent to determine whether it is necessary to disclose the nature and subject of an investigation (including the identity of the person being investigated) when contacting third parties in connection with a civil or criminal tax investigation. Some argue that identifying the taxpayer and the nature of the investigation (civil or criminal) are items of tax information that every witness will want to know. On the other hand, some would argue that there is a particular sensitivity to associating a taxpayer with a criminal investigation and that such disclosures should only be made if the witness is not willing to provide the information sought without such a disclosure.

The IRS has been the subject of several lawsuits over the disclosure of the fact of a criminal investigation.[292] The proposal would bring some certainty as to what is a permissible disclosure. However, some may argue that the delicate balance between a taxpayer's reasonable expectation of privacy and effective tax administration is upset if the IRS is given blanket authority to disclose the nature and target of an investigation in all circumstances. Proponents of the proposal note, however, that the disclosure would be permissive rather than mandatory and that agents would still be able to use their discretion as to whether a disclosure was necessary.

Prior Action

No prior action.

7. Impose penalty on failure to comply with electronic filing of returns

Present Law

The Code authorizes the IRS to issue regulations specifying which returns must be filed electronically.[293] There are several limitations on this authority. First, it can only apply to persons required to file at least 250 returns during the year.[294] Second, the IRS is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may be filed electronically by choice).

If a corporation fails to electronically file a corporate income tax return when required to do so, the corporation is deemed to have failed to file a return. The addition to tax for failure to file a return is five percent of the amount of tax required to be shown on the return for the first month and an additional five percent for each additional month (or fraction thereof) up to 25 percent.

For failure to file a tax-exempt organization return, the addition to tax is $20 a day for each day the failure continues. The maximum amount per return is $10,000 or 5 percent of the organization's gross receipts for the year, whichever is less. Organizations with annual gross receipts exceeding $1 million, however, are subject to an addition to tax of $100 per day, with a maximum of $50,000.

The Code specifically authorizes the Secretary to offer incentives to encourage electronic filing.

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[292] For example see Snider v. United States, 468 F.3d 500 (8th Cir. 2006); Gandy v. United States, 234 F.3d 281 (5th Cir. 2000).

[293] Sec. 6011(e).

[294] Partnerships with more than 100 partners are required to file electronically.

Description of Proposal

An assessable penalty is established for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The amount of the penalty is $25,000 for a corporation or $5,000 for a tax-exempt organization. For failure to file in any format, the existing penalty would remain, and the proposed penalty would not apply.

Effective date.–The proposal is effective for returns required to be electronically filed on or after January 1, 2009.

Analysis

Electronic filing provides efficiency and cost savings for the IRS. Electronic filing provides efficiency because the IRS is better able to make use of its computer infrastructure to target returns with audit potential. This in turn allows the IRS to utilize its resources in areas in which such efforts would be most fruitful. However, growth in electronic filing is slowing: a six percent increase in 2006, as compared with an 11 percent increase in 2005, 12 percent in 2004 and 17 percent in 2003. Congress set a goal for the IRS to have 80 percent of all federal tax returns filed electronically by 2007.

Paper processing is a labor intensive process for the IRS. The GAO has reported that electronic filing has enabled the IRS to close two paper processing centers, and saved 1600 staff years.[295] Thus some may argue that the efficiencies and cost savings justify imposing a penalty for failure to comply with electronic filing requirements. On the other hand, some may argue that a $25,000 penalty is disproportionate to any costs or efficiency loss incurred by the IRS.

Under the Treasury regulations, failure to file electronically when required to do so can be treated as a failure to file a return. Thus, the existence of a current penalty for failing to file electronically might weigh against creating a new penalty. On the other hand, treating a paper return as not filed could have harsh results in circumstances in which elections are made on such returns.

Some would argue that the IRS should use incentives, as authorized by the Code, rather than penalties to encourage electronic filing. Proponents of the proposal would counter that it is not necessary for the IRS to offer incentives for what taxpayers are obligated to do and that in the absence of hardship, the burden on a taxpayer to file electronically is minimal and yields significant tax administration benefits for the IRS.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposals.

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[295] Government Accountability Office, GAO-07-27, Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings (November 2006).

V. IMPROVE TAX ADMINISTRATION AND OTHER MISCELLANEOUS PROPOSALS

A. Modify Section 1203 of the IRS Restructuring and Reform Act of 1998

Present Law

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

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

Description of Proposal

The proposal removes the following from the list of violations requiring termination: (1) the late filing of refund returns; and (2) employee versus employee acts. The proposal also adds unauthorized inspection of returns and return information to the list of violations requiring termination. Additionally, the proposal requires the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by section 1203 of the IRS Restructuring and Reform Act of 1998. The Commissioner retains the non-delegable authority to determine whether mitigating factors support a personnel action other than that specified in the guidelines for a covered violation.

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

Analysis

Late filing of refund returns

The proposal has the effect of treating IRS employees more like individuals employed by any other employer, with respect to late filing of refund returns. Late filing generally is not grounds for termination by most employers. In addition, late filing of refund returns is generally not subject to penalty under the Code.[296] Proponents of the proposal relating to late filings argue that the late filing of a refund return is not the type of serious conduct for which the severe penalties imposed by the IRS Restructuring and Reform Act should apply. Others argue that IRS employees, as the enforcers of the country's tax laws, should be held to a higher standard and be required to timely file all income tax returns. On the other hand, removing late filing of refund returns and employee versus employee conduct from the list of section 1203 violations may make it easier for the IRS to administer section 1203, as there would be fewer types of allegations that would require section 1203 review and investigation.

Employee vs. employee allegation

Advocates of removing employee versus employee misconduct from the list of grounds for IRS employee termination argue that allegations of willful conduct by IRS employees against other IRS employees can be addressed by existing administrative and statutory procedures. Other means, such as the Whistleblower Protection Act, negotiated grievance processes, and civil rights laws, exist to address employee complaints and appeals. Moreover, it is argued that under present-law rules, parallel investigative and adjudicative functions for addressing employee complaints and appeals are confusing to employees and burdensome for the IRS.

Proponents also believe that it is appropriate to remove employee versus employee conduct from the list of section 1203 violations because, unlike other section 1203 violations, such conduct does not violate taxpayer protections. On the other hand, opponents point out that Congress believed it appropriate to include such conduct in the statutory list of grounds for IRS employee termination. They argue that including employee versus employee conduct in the section 1203 violation list benefits tax administration. Another issue to consider is the extent to which the inclusion of employee versus employee conduct on the list of section 1203 violations deters inappropriate behavior (by reducing the likelihood of real employee versus employee actions) or increases inappropriate behavior (by increasing the number of allegations of inappropriate behavior against other employees for purposes of intimidation, harassment, or retribution).

Unauthorized inspection of returns

Advocates of the proposal argue that unauthorized inspection of tax returns and return information is a serious act of misconduct that should be included in the list of violations subject to termination, as unauthorized inspection is as serious as the other taxpayer rights protections

[296] The refund claim must be filed prior to the expiration of the applicable statute of limitations for the taxpayer to receive the refund.

covered by section 1203. Code section 7213A already makes the unauthorized inspection of returns and return information illegal, with violations punishable by fine, imprisonment, and discharge from employment. Even though unauthorized inspection is punishable under a separate law, it is argued that extending section 1203 coverage to unauthorized inspection will strengthen the IRS' power to discipline without the penalty being overturned.

On the other hand, opponents of this part of the proposal note that most violations of Code section 7213A are not prosecuted, but employees are subject to discipline based on administrative determination. The IRS policy has been to propose termination of employment in cases of unauthorized inspection, but in a number of recent cases, arbitrators and the Merit Systems Protection Board have overturned the IRS' determination to terminate employees for such violations.

Advocates also argue that adding unauthorized inspection of returns to the list of section 1203 violations will prevent overturning of the IRS' determination of the level of appropriate employee punishment. Some question whether it is appropriate to use an internal administrative process to achieve a result that the IRS states that it has been unable to achieve through judicial or external administrative processes. In addition, adding unauthorized inspection of returns to the list of section 1203 violations could add to the fear of IRS employees that they will be subject to unfounded allegations and lose their jobs as a result, which might deter fair enforcement of the tax laws.

The position taken by the IRS with respect to this part of the proposal can be criticized as inconsistent with its position on the employee versus employee allegations piece of the proposal. The IRS argues that employee versus employee conduct should be removed from the list of section 1203 violations because such conduct can be addressed by existing administrative and statutory procedures, while at the same time the IRS argues that unauthorized inspection of returns should be added to the list of violations even though it is punishable under a separate law. Some view these positions as inconsistent.

While the proposal makes unauthorized inspection (which is a misdemeanor) a section 1203 violation, it does not make unauthorized disclosure (which is a felony under Code section 7213) a section 1203 violation. Arguably, more damage can be done by disclosing sensitive tax information to a third party than by looking at a return out of curiosity. Thus, the proposal can be criticized as lacking the proper focus.

Adding unauthorized inspection of returns to the list of violations also may complicate IRS administration, as there would likely be an increase in the number of 1203 violations requiring IRS review and investigation. Moreover, because unauthorized inspection of returns violations under Code section 7213A are currently subject to discipline based on administrative determination by the IRS, adding such violations to the list of section 1203 violations would require the IRS to change current practice and follow section 1203 procedures instead.

Penalty guidelines

Some are concerned that the IRS' ability to administer the tax laws efficiently is hampered by a fear among employees that they will be subject to false allegations and possibly

lose their jobs. Proponents of the proposal requiring the IRS to publish detailed guidelines argue that these guidelines are needed to provide notice to IRS employees of the most likely punishment that will result from specific violations. They believe that the certainty provided by specific guidelines would improve IRS employee morale and enhance the fundamental fairness of the statute.

Others argue that since Congress intended for the section 1203 violations to warrant termination, it is not appropriate to allow the IRS to determine a lesser level of punishment. Additionally, they argue that the claim that penalty guidelines are necessary is inconsistent with the proposal to remove from the list the two violations that are said to most often warrant punishment other than that required under section 1203 (late filed refund returns and employee versus employee allegations).

Prior Action

An identical proposal was included in the President's fiscal year 2003 through 2008 budget proposals.

B. Termination of Installment Agreements

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments, if the IRS determines that doing so will facilitate collection of the amounts owed.[297] An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate or incomplete information when applying for an installment agreement; (5) there has been a significant change in the financial condition of the taxpayer; or (6) the collection of the tax is in jeopardy.[298]

Description of Proposal

The proposal grants the IRS authority to terminate an installment agreement when a taxpayer fails to timely make a required Federal tax deposit[299] or fails to timely file a tax return.

Effective date.–The proposal is effective for failures occurring on or after the date of enactment.

Analysis

The proposal reflects the policy determination that taxpayers who are permitted to pay their tax obligations through an installment agreement should also be required to remain current with their other Federal tax obligations. Some are concerned that this does not take into account the benefits of making continued installment payments. A key benefit to the government of continued installment payments is that the government continues to receive payments, whereas if the installment agreement is terminated payments under that agreement stop. Some note that termination of the installment agreement permits the IRS to begin immediate collection actions,

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[297] Sec. 6159.

[298] Sec. 6159(b).

[299] Failure to timely make a required Federal tax deposit is not considered to be a failure to pay any other tax liability at the time such liability is due under section 6159(b)(4)(B) because liability for tax generally does not accrue until the end of the taxable period, and deposits are required to be made prior to that date (sec. 6302).

such as reinstating liens and levies, which could increase government receipts. In the past several years, however, there has been a significant decline in IRS' enforced collection activities. Thus, others respond that terminating installment agreements might not lead to increased receipts to the government, in that the cessation of receipts due to termination of installment agreements may outweigh increases in receipts through additional enforcement activities.

The proposal is effective for failures occurring on or after the date of enactment. Some question whether it is fair to taxpayers who are currently in an installment agreement to terminate those agreements. To address this concern in part, as well as fairness concerns more generally, it may be beneficial to permit the reinstatement of terminated installment agreements for reasonable cause, in a manner parallel to the procedures applicable to offers in compromise.

Prior Action

An identical proposal was included in the President's fiscal year 2003 through 2008 budget proposals.

C. Office of Chief Counsel Review of Offers in Compromise

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer in compromise. IRS regulations provide that such offers can be accepted if the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Compromises with respect to unpaid tax liabilities of $50,000 or more can be accepted only if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel.[300] The $50,000 threshold was raised from $500 in 1996.[301]

Description of Proposal

The proposal repeals the requirement that an offer-in-compromise with respect to unpaid tax liabilities of $50,000 or more must be supported by a written opinion from the Office of Chief Counsel. Under the proposal, the Secretary must establish standards for determining when a written opinion is required with respect to a compromise.

Effective date.–The proposal applies to offers-in-compromise submitted or pending on or after the date of enactment.

Analysis

Repealing the requirement that an offer-in-compromise of $50,000 or more be supported by a written opinion from the Office of Chief Counsel will simplify the administration of the offer-in-compromise provisions by the IRS. Repealing this requirement also would increase the level of discretionary authority that the IRS may exercise, which may lead to increasingly inconsistent results among similarly situated taxpayers. Some believe that Chief Counsel review is appropriate for all offers-in-compromise above specified dollar thresholds, similar to the review of large refund cases by the Joint Committee on Taxation.[302]

Prior Action

An identical proposal was included in the President's fiscal year 2003 through 2008 budget proposals.

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[300] Sec. 7122.

[301] Sec. 503 of the Taxpayer Bill of Rights 2 (Pub. L. No. 104-168; July 30, 1996).

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

D. Extension of IRS Authority to Fund Undercover Operations

Present Law

IRS undercover operations are statutorily[303] exempt from the generally applicable restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the Code permits the IRS to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation, through December 31, 2007. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

Description of Proposal

The proposal extends this authority through December 31, 2012.

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

Analysis

Some believe the extension of this authority is appropriate because it assists the fight against terrorism. Some also believe that it is appropriate for IRS to have this authority because other law enforcement agencies have churning authority. Others point to the four and a half year gap during which the provision had lapsed as evidence that this authority is not essential to the operation of the IRS. However, it is difficult to show what investigative opportunities were lost due to the lack of churning authority during that period. Some believe that extension is inappropriate because the provision may provide incentives to continue undercover operations for extended periods of time. For example, IRS data for fiscal years 2002, 2003, and 2004 reveal that a total of approximately $748,000 was churned while only $6,700 was deposited in the general fund of the Treasury due to the cessation of undercover operations.

Prior Action

The provision was originally enacted in The Anti-Drug Abuse Act of 1988.[304] The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990[305] to December 31, 1991.[306] There followed a gap of approximately

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[303] Sec. 7608(c).

[304] Sec. 7601(c) of Pub. L. No. 100-690 (Nov. 18, 1988).

[305] Sec. 3301 of Pub. L. No. 101-647 (Nov. 29, 1990).

[306] The Ways and Means Committee Report stated: "The committee believes that it is appropriate to extend this provision for two additional years, to provide additional time to evaluate its effectiveness." H.R. Rep. No. 101-681, Part 2, p. 5 (September 10, 1990).

four and a half years during which the provision had lapsed. In the Taxpayer Bill of Rights II,[307] the authority to churn funds from undercover operations was extended for five years, through 2000.[308] The Community Renewal Tax Relief Act of 2000[309] extended the authority of the IRS to "churn" the income earned from undercover operations for an additional five years, through 2005. The Gulf Opportunity Zone Act of 2005 extended this authority through 2006.[310] The Tax Relief and Health Care Act of 2006[311] extended the authority through December 31, 2007.

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[307] Pub. L. No. 104-168, sec. 1205 (July 30, 1996).

[308] The Ways and Means committee report stated: "Many other law enforcement agencies have churning authority. It is appropriate for IRS to have this authority as well." H.R. Rep. No. 104-506, p. 47 (March 28, 1996). The Senate passed the House bill without alteration.

[309] Pub. L. No. 106-554.

[310] Pub. L. No. 109-135.

[311] Pub. L. No. 109-432.

E. Increase Transparency of the Cost of Employer-Provided Health Coverage

Present Law

An employer is subject to certain withholding requirements with respect to wages that the employer pays to an employee. Amounts withheld pursuant to these requirements are paid by the employer to the Federal government for advance payment of the employee's Federal income tax liability and for the employee's share of FICA (Federal Insurance Contributions Act) taxes.[312] For purposes of the withholding requirements, wages include all remuneration for employment, including the cash value of remuneration paid in a medium other than cash. Wages, however, do not include the value of employer-provided health insurance coverage.[313]

An employer that is required to withhold wages pursuant to the requirements described above is also required to furnish an annual statement to the employee with respect to the amounts withheld for the year.[314] The statement is required to be provided on or before January 31 of the succeeding year. The IRS has issued Form W-2 for purposes of satisfying this requirement. There is no general requirement to disclose the value of employer-provided health coverage on Form W-2, although reporting is required with respect to certain types of health benefits. Specifically, the amount contributed for the year to an Archer medical savings account ("Archer MSA") or a health savings account ("HSA") must be disclosed on Form W-2.

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), certain group health plans must offer continuation of coverage under the plan ("COBRA continuation coverage") for a period of time to a plan participant who has experienced a qualifying event, such as a termination of employment with the employer that sponsors the plan.[315] A group health plan generally means a plan of an employer that provides health care to its employees.[316] If a participant elects COBRA continuation coverage, the plan is permitted to require that the participant pay a premium for such coverage. However, the premium is not permitted to exceed 102 percent of the applicable premium for the period of coverage.[317] In general, the applicable premium means the cost to the plan for the period of coverage for similarly situated beneficiaries with respect to whom a qualifying event has not occurred.

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[312] Secs. 3102 and 3402.

[313] Secs. 3121(a)(2) and Rev. Rul. 56-632, 1956-2 C.B. 101.

[314] Sec. 6051. The requirement to provide an annual statement also applies if the employer would have been required to withhold for the employee's income tax liability if the employee had claimed no more than one withholding allowance or had not claimed an exemption from withholding.

[315] Sec. 4980B.

[316] Secs. 4980B(g)(2) and 5000(b)(1).

[317] Sec. 4980B)(f)(2)(C).

Special rules apply for purposes of determining the applicable premium in the case of a self-insured plan.[318]

Description of Proposal

The proposal requires the disclosure of the value of employer-provided health coverage on Form W-2. If an employee receives coverage under multiple plans (e.g., the employer provides separate health, dental, and vision policies), the aggregate value received by the employee would be disclosed. Coverage under a health flexible spending arrangement and contributions to an Archer MSA or HSA would not be included in the disclosure.

An employer would determine the value of coverage in the same manner as the employer would determine the applicable premium for COBRA continuation coverage. The value of the coverage would not vary on account of the health status or claims experience of a particular employee. Thus, coverage under a particular plan would be valued the same for similarly situated employees who receive the same type of coverage (e.g., employee-only or family coverage).

Effective date.–The proposal does not provide a specific effective date.

Analysis

The proposal is designed to educate employees of the value of employer-provided health coverage. Some argue that employees have little information about the cost or value of such coverage and thus are not in a position to make an informed decision when choosing health care coverage. Some believe that requiring disclosure of the cost of health insurance coverage to employees will lessen over-consumption of health coverage or inefficient choices with respect to such coverage. Proponents also believe that disclosure will provide employees with the information necessary to negotiate optimal compensation packages.

Others observe that if consumer education is the ultimate goal of the proposal, disclosure on Form W-2 may not be an effective means of information transmittal. Disclosure on Form W-2 may not coincide with an employee's enrollment opportunities with respect to employer-provided coverage and thus the information may arrive too late or too early with respect to the relevant decision-making date. Form W-2 is primarily designed to assist an employee's annual Federal income tax filing obligation. As a result, the form contains numerous wage and benefit amount disclosures, almost all of which are unrelated to health insurance coverage, and thus an employee may easily overlook the health coverage information, particularly since the health coverage disclosure does not relate to the employee's Federal income tax obligation.

The foregoing concerns regarding the effectiveness of the proposal are not relevant to the extent that the proposal is offered in conjunction with the proposal that replaces the present-law income tax treatment of employer-provided health coverage (and other present-law rules relating to the tax treatment of health coverage) with a standard deduction for health insurance coverage

[318] Sec. 4980B(f)(4).

(discussed previously). If such a proposal were to be enacted, disclosure of the value of employer-provided health coverage on Form W-2 would facilitate an employee's Federal income tax filing obligation.

Prior Action

A similar disclosure requirement was included in the President's fiscal year 2008 budget proposal as part of the proposal for a standard deduction for health insurance coverage.

F. Conform Penalty Standards for Preparers and Taxpayers

Present Law

Taxpayer standards

Present law imposes accuracy-related penalties on a taxpayer at a rate of 20 percent of the portion of any underpayment that is attributable to any substantial understatement of income tax. In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Tax return preparer standards

Under prior law, an income tax return preparer who prepared a tax return with respect to which there was an understatement of tax that was due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits was liable for a $250 penalty. For a disclosed position, the preparer was liable only if the position was frivolous.

Legislation enacted as part of the Small Business and Work Opportunity Tax Act of 2007 broadened the scope of the preparer penalty by applying it to all tax return preparers and altered the standards of conduct a tax return preparer is required to meet in order to avoid the imposition of penalties for the preparation of a return with respect to which there is an understatement of tax. A tax return preparer now can be penalized for preparing a return on which there is an understatement of tax liability as a result of an "unreasonable position." Any position that a return preparer does not reasonably believe is more likely than not to be sustained on its merits is an "unreasonable position" unless the position is disclosed on the return and there is a reasonable basis for the position.

In general, the term "tax return preparer" is broadly defined as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax or any claim for refund of tax.[319] Preparation of a substantial portion of a return is treated as if it were the preparation of such return.[320] In certain cases an attorney giving advice with respect to specific issues of law can be treated as a tax return preparer.[321]

Description of Proposal

The proposal changes the standard for undisclosed positions other than reportable transactions to which section 6662A applies, i.e., reportable transactions with significant

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[319] Sec. 7701(a)(36)(A).

[320] *Id.*

[321] *See* Treas. Reg. sec. 301.7701-15(a)(2).

avoidance or evasion purposes. The general preparer standard for undisclosed positions would be reduced to "substantial authority." The preparer standard for reportable transactions with a significant avoidance or evasion purpose would remain where it is under current law, and a preparer would not be penalized if he had a reasonable belief that such a transaction was more likely than not to be sustained on its merits.

Effective date.–The proposal would be effective for returns prepared after January 1, 2008.

Analysis

Since the enactment of the 2007 change to the return preparer standards, many tax lawyers and accountants have argued that the mismatch between return preparer and taxpayer standards can result in a conflict of interest for return preparers. For example, in a situation in which there is "substantial authority" for a return position but it is not more likely than not that the position would be sustained on its merits, it is in the interest of a preparer to advise his taxpayer client to either disclose the position or alter the position (to avoid the preparer penalty) even though the taxpayer could legally and appropriately take the position without facing penalties. Preparers have complained that the asymmetry between the standards forces them out of their traditional role as advocates for their clients and into the role of auditors. Some have suggested that the current standard of conduct may even cause taxpayers to be less inclined to use the services of professional tax preparers and, as a result, could harm the system of tax collections.

There are at least two ways to address the conflict of interest issue that arguably resulted from raising preparer standards above those that apply to taxpayers: tax preparer standards could be lowered so that they are the same as taxpayer standards in most cases (as under the proposal), or taxpayer standards could be raised to the level set for preparers under present law. The proposal lowers the preparer standards (rather than raising taxpayer standards) on the grounds that raising taxpayer standards would present "significant administrative concerns" and "result in the unfair application of the accuracy related penalty." In addition, proponents express concern about the application of the more likely than not standard to many "routine" reporting positions.

Presumably, concern regarding administrative problems that might result from applying a more-likely-than-not standard to taxpayers stems from the assumption that the number of additional disclosures on tax returns of positions not meeting the standard would be significant, and the value of such disclosures would be questionable if the IRS were inundated by them. On the other hand, additional disclosure of positions that do not meet the more-likely-than-not standard may be seen as a positive result, which would be further facilitated by raising the taxpayer standard rather than lowering the preparer standard.

Preparers also have maintained that many non-abusive return positions cannot be determined to be correct at a more-likely-than-not level of certainty. As a result, such preparers likely would recommend the disclosure of such positions. But this argument against the enhanced standard is effectively the same as the argument that additional disclosure may cause administrative difficulties. Such difficulties might be addressed through the issuance of

administrative guidance for those transactions or positions that the IRS determines do not raise compliance concerns.

Finally, proponents argue that the enhanced standard now applied to preparers may result in the unfair application of the penalty, presumably to positions for which there is substantial authority but that are not more likely than not to be sustained on the merits. The penalty only applies, however, to such positions when they are not disclosed.

Raising the standard that applies to taxpayers as opposed to lowering the standard that applies to preparers could address the conflict of interest problem while also fostering self-reporting by taxpayers and increasing the perception that the tax system is fair by making it more likely that aggressive positions on tax returns will be penalized. In 1999, the staff of the Joint Committee on Taxation considered the standards of conduct that should apply to taxpayers and return preparers and recommended that a uniform more-likely-than-not standard apply to both taxpayers and tax preparers for each undisclosed position on a tax return.[322] In that report, the Joint Committee staff reasoned that the more appropriate standard "would require that a taxpayer or a tax advisor, who does not disclose an uncertain position, be required to show that any undisclosed positions taken on the return are at least probably correct."[323]

Prior Action

No prior action. A similar provision was included in H.R. 4318, introduced December 6, 2007.

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[322] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters* (JCS-3-99), July 22, 1999, Volume I, p. 156.

[323] *Id.*

G. Eliminate the Special Exclusion from Unrelated Business Taxable Income ("UBIT") for Gain or Loss on Sale or Exchange of Certain Brownfield Properties

Present Law

In general

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business regularly carried on 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 a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.[324]

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include: (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption; (2) obligations to pay certain types of annuities; (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons; or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.[325]

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.[326]

Exclusion for sale, exchange, or other disposition of brownfield property

Present law provides an exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property

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[324] Secs. 511-514.

[325] Sec. 514.

[326] Secs. 512(c).

by an eligible taxpayer.[327] The exclusion from unrelated business taxable income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In addition, there is an exception from the debt-financed property rules for such properties.

In order to qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.[328]

Qualifying brownfield properties

The exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"). The taxpayer's request for certification must include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the property's presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield property in an amount that exceeds the greater of: (a) $550,000; or (b) 12 percent of the fair

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[327] Secs. 512(b)(19).

[328] A person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.[329]

Qualified sale, exchange, or other disposition

A sale, exchange, or other disposition of a qualifying brownfield property shall be considered as qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a "remediation certification") from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer's remediation actions, such property would not be treated as a qualifying brownfield property in the hands of the transferee. A taxpayer's request for a remediation certification shall be made no later than the date of the transfer and shall include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;[330] (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical

[329] In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

[330] For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

improvements required to remediate the property, is either complete or substantially complete, and if substantially complete,[331] sufficient monitoring, funding, institutional controls, and financial assurances have been put in place to ensure the complete remediation of the site in accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of the provision)) was completed before the date of such request. Public notice shall include, at a minimum, publication in a major local newspaper of general circulation.

A copy of each of the requests for certification that the property was a brownfield site, and that it would no longer be a qualifying brownfield property in the hands of the transferee, shall be included in the tax return of the eligible taxpayer (and, where applicable, of the qualifying partnership) for the taxable year during which the transfer occurs.

Eligible remediation expenditures

Eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,[332] or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample, study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property, or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional liability coverage, or similar types of coverage;[333] (3) any amount paid or incurred to the extent

[331] For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

[332] Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

[333] For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage

such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the proposal.[334]

Qualified gain or loss

In general, the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property is excluded from unrelated business taxable income. Income, gain, or loss from other transfers is not excluded.[335] The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. The exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.[336]

Special rules for qualifying partnerships

In general

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the exclusion applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the

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under policies referred to as owner-controlled insurance. Owner/operator liability coverage is coverage for those parties that own the site or conduct business or engage in cleanup operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

[334] The Secretary of the Treasury is authorized to issue guidance regarding the treatment of government-provided funds for purposes of determining eligible remediation expenditures.

[335] For example, rent income from leasing the property does not qualify for the exclusion.

[336] Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (Treas. Reg. Secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

disposition of the property.[337] A qualifying partnership is a partnership that (1) has a partnership agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property; (2) satisfies the requirements of the proposal if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.[338]

The Secretary is required to prescribe such regulations as are necessary to prevent abuse of the requirements of the provision, including abuse through the use of special allocations of gains or losses, or changes in ownership of partnership interests held by eligible taxpayers.[339]

Certifications and multiple property elections

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying brownfield properties, however, may elect to make the eligible remediation expenditure

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[337] The exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest.

[338] A tax-exempt partner is subject to tax on gain previously excluded by the partner (plus interest) if a property subsequently becomes ineligible for exclusion under the qualifying partnership's multiple-property election.

[339] Such regulations have not yet been issued.

determinations on a multiple-property basis. In the case of such an election, the taxpayer satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) $550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.[340]

An acquiring taxpayer makes a multiple-property election with its timely filed tax return (including extensions) for the first taxable year for which it intends to have the election apply. A timely filed election is effective as of the first day of the taxable year of the return in which the election is included or a later day in such taxable year selected by the taxpayer. An election remains effective until the earliest of a date selected by the taxpayer, the date which is eight years after the effective date of the election, the effective date of a revocation of the election, or, in the case of a partnership, the date of the termination of the partnership.

A taxpayer may revoke a multiple-property election by filing a statement of revocation with a timely filed tax return (including extensions). A revocation is effective as of the first day of the taxable year of the return in which the revocation is included or a later day in such taxable year selected by the eligible taxpayer or qualifying partnership. Once a taxpayer revokes the election, the taxpayer is ineligible to make another multiple-property election with respect to any qualifying brownfield property subject to the revoked election.[341]

Debt-financed property

Debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other disposition of which is excluded by reason of the portions of the Code that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the provision is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

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[340] If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

[341] A taxpayer is subject to tax on gain previously excluded (plus interest) in the event a site subsequently becomes ineligible for gain exclusion under the multiple-property election.

Termination date

Under present law, the exclusion is available only for gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009 (the "termination date"). Property acquired during the five-year acquisition period need not be disposed of by the termination date in order to qualify for the exclusion. For purposes of the multiple property election, gain or loss on property acquired after December 31, 2009, is not eligible for the exclusion from unrelated business taxable income, although properties acquired after the termination date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

Description of Proposal

The proposal eliminates the special exclusion for gain or loss on the sale, exchange, or other disposition of remediated brownfield property from unrelated business taxable income and the debt-financed property rules.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2008.

Analysis

The proposal repeals the exclusion for gains from the disposition of remediated brownfield property from unrelated business income tax rules, citing administrative and policy concerns.

Administrative concerns

The proposal states that the exclusion adds significant complexity to the Code and is difficult to administer. By any measure, the exclusion is complicated; and the exclusion's complexity presents several administrative challenges. In general, although the policy of the proposal is simple -- exempt entities should not be deterred by unrelated business income tax rules from investing in contaminated properties for the purposes of remediating the property prior to sale -- the exclusion mechanically is complex in order to prevent abuse and because of the difficult and technical nature of the problem being addressed. The question raised by the proposal essentially is whether such requisite complexity makes the exclusion too difficult to administer and thus, ineffective policy at best, and susceptible to abuse at worst.

Although the proposal does not cite specific administrative concerns, there are several aspects of the exclusion that might be at issue. For example, the exclusion requires that remediation expenses on brownfield property be incurred in an amount that exceeds the greater of $550,000 or 12 percent of the fair market value of the property determined at the time the property is acquired and as if the property were not contaminated. Such a determination of value may be difficult for the IRS to enforce, with the effect of making the $550,000 component of the test a ceiling and not a floor for required remediation expenses. Also, the remediation expense test may be applied on a property-by-property basis or, by an election, on a multiple property basis. Under the multiple property test, in general, all the remediation expenses and

noncontaminated values of properties acquired within an eight-year period are taken into account. Because the election period potentially is eight years, and tens or hundreds of properties could be sold during such time, it could be difficult for the IRS to determine whether bona fide remediation expenses were made with respect to each property or what the respective noncontaminated values of the properties are.

Another area of concern for the IRS might be that the exclusion is not extended to certain persons that are potentially liable under CERCLA with respect to the acquired property. This may require the IRS to make determinations under environmental laws, which may prove difficult. The exclusion also requires the taxpayer to provide the IRS with copies of certifications that the property was, prior to remediation, a qualified brownfield property and that, at the time of disposition, the property no longer is a brownfield property. Although the IRS is not involved in the certification process (the EPA and State agencies generally are responsible for issuing such certifications), the IRS must maintain the certifications, perhaps for many years, and examine them in order to test the validity of the exclusion.

A significant administrative concern also might be determining whether an expense is an eligible remediation expense, which is a matter of critical importance to the policy supporting the exclusion. The definition of an eligible expense is detailed and descriptive, but not precise. Given the complexity of the definition, it likely will be resource intensive and difficult for the IRS to challenge a taxpayer's accounting of remediation expenses.

Another complicating factor is that qualified property may have gain that is excludable because of the special rules and gain that is not excludable, such as rental income from the property. The exclusion also does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including certain section 198 expenses. Although these rules are clear, it may nonetheless be difficult for the IRS to administer in the context of a provision that excludes some kinds of gain and taxes others.

The exclusion also has special rules for partnerships (which likely is the vehicle that will often be utilized for purposes of the exclusion), which require, among other things that the Secretary issue regulations to prevent abuse, including abuse through the use of special allocations of gains or losses or changes in ownership of partnership interests held by eligible taxpayers. The exclusion also contains a related-party rule and a recapture provision, which contribute to the administrative complexity of the exclusion.

By virtue of the proposal to repeal the exclusion, the President has concluded, albeit without identifying specific areas of concern, that the administrative complexity engendered by the exclusion outweighs any policy benefits that may result from the exclusion.

Policy concerns

The President expresses the concern that the exclusion is not sufficiently targeted because it excludes from unrelated business income all of the gain from the disposition of qualified property, irrespective of whether the gain is attributable to remediation by the taxpayer. Under this view, arguably the exclusion should be provided only to gain that results from remediation activity, and permitting the exclusion of gain resulting from nonremediation-related property

development provides an unwarranted windfall to the taxpayer. Some might argue that the proposal is broad by design in order to encourage the development of contaminated sites, because without the benefit of exclusion for all of a property's gain, taxpayers will not have a sufficient incentive to acquire and remediate contaminated property. Nevertheless, the multiple property election of the proposal may permit taxpayers to acquire a brownfield site where little remediation is required, significantly develop the property, and sell the property without paying tax on the gain so long as the average expenses over all the properties meet the requirements of the multiple property election.

Prior Action

The President's fiscal year 2006, 2007, and 2008 budget proposals included a similar proposal.

H. Impose Stricter Limits on Related-Party Interest Deductions by Expatriated Entities

Present Law

In general

A U.S. corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Generating excessively large U.S. tax deductions in this manner is known as "earnings stripping."[342] Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned U.S. corporations may use certain treaties to facilitate certain earnings stripping transactions without having their deductions offset by U.S. withholding taxes.[343] For example, the foreign parent company may arrange for the loan to be made by a foreign affiliate located in a treaty country.

Although the term "earnings stripping" may be broadly applied to the generation of excessive deductions for interest, rents, royalties, management fees and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions.[344] In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Earnings stripping limitations

Present law limits the ability of foreign corporations to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through earnings stripping transactions. If the

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[342] It may also be possible for domestic-controlled corporations to engage in earnings stripping by making excessive deductible payments to foreign corporations which they control. In general, however, this type of tax planning is precluded by the anti-deferral rules of subpart F.

[343] For example, it appears that the U.S.-Barbados income tax treaty was used to facilitate earnings stripping. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. See the discussion in the Analysis section. See also Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Barbados* (JCX-55-04), September 16, 2004, at 12-20, 22.

[344] Herein, except when noted otherwise, "earnings stripping" refers to the generation of excessive interest deductions.

payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5-to-1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed to the extent that the payor's "net interest expense" (i.e., the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, depreciation, amortization, and depletion).[345] Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such interest;[346] or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Corporate inversion transactions

The American Jobs Creation Act of 2004 ("AJCA") added new section 7874 to the Code.[347] That section defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. In an inversion transaction, a U.S. parent company is replaced with a foreign parent. The first type of inversion is a transaction in which (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003;[348] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership, does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Section 7874 denies the intended tax benefits of this type of inversion ("80-percent inversion") by deeming the top-tier foreign corporation to be a domestic corporation for all tax purposes.

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met.

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[345] Sec. 163(j).

[346] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

[347] Pub. L. No. 108-357, sec. 801(a) (2004).

[348] A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

In such a case, if a 60-percent ownership threshold is met, then a second set of rules applies to the inversion ("60-percent inversion"). Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not generally offset by tax attributes such as net operating losses. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, generally without offset by any tax attributes (e.g., net operating losses). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.[349]

In both types of inversions, the domestic corporation (or partnership) that becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003, or any United States person related to such a domestic corporation (or partnership), is referred to as an "expatriated entity."[350]

Treasury Department report on earnings stripping

AJCA also required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005 ("Treasury earnings stripping report"), examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the provisions of the Code applicable to earnings stripping.[351] The report, which was submitted to Congress on November 28, 2007,[352] is discussed in the Analysis section.

Description of Proposal

The proposal modifies the earnings stripping deduction limitations applicable to expatriated entities, in the case of corporate inversions. Under the proposal, expatriated entities may not utilize the 1.5-to-1 debt-to-equity ratio safe harbor. In addition, the proposal reduces the present-law threshold of 50 percent of adjusted taxable income to 25 percent with respect to interest paid or accrued by expatriated entities on related-party debt. With respect to interest on

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[349] Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met.

[350] Sec. 7874(a)(2).

[351] Pub. L. No. 108-357, sec. 424 (2004).

[352] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 28, 2007. The report also includes AJCA-mandated studies on transfer pricing and U.S. income tax treaties.

guaranteed debt, the present-law threshold of 50 percent of adjusted taxable income is retained. The proposal also limits the carryforward of disallowed interest to 10 years and eliminates the excess limitation carryforward.

The proposal generally applies in the case of any corporate inversion (regardless of whether the inversion is a 60-percent inversion or 80-percent inversion) that occurred in taxable years beginning after July 10, 1989. For purposes of the proposal, the term "expatriated entity" generally means an expatriated entity as defined under present-law section 7874, except that the term applies with respect to inversions occurring after July 10, 1989 rather than inversions occurring after March 4, 2003.[353] However, the proposal does not apply in the case of an 80-percent inversion in which the top-tier foreign corporation is treated as a domestic corporation for all tax purposes under section 7874.

Effective date.–The proposal is effective for interest paid or accrued on or after the date of enactment.

Analysis

Earnings stripping in connection with inversion transactions

Recent inversion transactions led some, including the Department of the Treasury, to question the efficacy of the present-law earnings stripping rules.[354] In some cases, it appeared that the earnings stripping benefit achieved when a U.S. corporation paid deductible amounts to its new foreign parent or other foreign affiliates constituted the primary intended tax benefit of the inversion transaction, which should not have been the case if the earnings stripping rules had been functioning properly.[355] The Treasury earnings stripping report concludes that "there is strong evidence that inverted corporations are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in

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[353] This rule aligns the applicability of the inversion rules with the effective date of the original earnings stripping provision. The earnings stripping rules (section 163(j)) are generally applicable to instruments issued after July 10, 1989, with a grandfather rule for acquisitions made (or subject to a binding contract) on or before July 10, 1989.

[354] *See, e.g.*, Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003, 104 ("Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 17, 2002, Part VII.A ("Treasury study") ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited").

[355] *See, e.g.*, Treasury study, Part VII.A; Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, 3-4.

preventing them from engaging in earnings stripping."[356] In reaching this conclusion, the Treasury earnings stripping report largely relies on an outside study of twelve inverted corporations (the "Seida and Wempe study")[357] and a supplemental Treasury Department analysis of payments declared on Form 5472.[358]

The proposal would change the earnings stripping rules for expatriated entities only. By eliminating the debt-equity safe harbor,[359] reducing the adjusted taxable income threshold from 50 percent to 25 percent for interest on related-party debt, limiting the carryforward of disallowed interest to 10 years, and eliminating the carryforward of excess limitation, the proposal significantly strengthens rules that have proven ineffective in preventing certain recent earnings stripping arrangements in the context of corporate inversion transactions.[360]

Earnings stripping by foreign-controlled domestic corporations - the conclusions of the Treasury report

The Treasury earnings stripping report presents three separate analyses using tax data to test whether foreign-controlled domestic corporations are engaging in earnings stripping outside

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[356] Treasury earnings stripping report, at 26.

[357] Seida and Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, 57 National Tax Journal 805-28 (2004). The Seida and Wempe study found that the 12 inverted corporations had a significantly larger increase in foreign income and a significantly larger decrease in U.S. profit margin and effective tax rate than a control group of corporations. The Seida and Wempe study also more closely examined four inverted corporations for which detailed information on the levels of intercompany debt and interest and fee expense were readily available, and found that these levels increased significantly post-inversion. Moreover, for three of those four corporations, information could be determined regarding the geographic location of these attributes, and with respect to those three, most of the long-term debt, interest, and fee income was attributable to the U.S. operations. Treasury earnings stripping report, at 21-22.

[358] Form 5472 is an information return of (1) a U.S. corporation owned 25 percent or more by one foreign person, or (2) a foreign corporation engaged in a trade or business within the United States. Such reporting is required under sections 6038A and 6038C. Form 5472 includes information on cross border payments, including fees, interest, and royalties, between the reporting corporation and foreign-related persons.

[359] The Treasury earnings stripping report states that all of the four more closely examined inverted corporations in the Seida and Wempe study appear to be within the 1.5-to-1 debt-to-equity safe harbor. Treasury earnings stripping report, at 23; see Seida and Wempe study, at 821.

[360] The Treasury earnings stripping report acknowledges that section 806 of AJCA requires the Treasury Department to conduct a study of the effectiveness of the provisions of AJCA relating to corporate expatriation, including the formulation of recommendations on improving the effectiveness of those provisions. The Treasury Department intends to separately issue to the Congress the report on that study. Nonetheless, the Treasury earnings stripping report states that "section 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." Treasury earnings stripping report, at 3.

the context of inversion transactions. First, the Treasury earnings stripping report examines the relative profitability of foreign-controlled domestic corporations and domestic-controlled corporations by comparing the ratios of net income to total receipts, concluding that foreign-controlled domestic corporations are generally less profitable than their domestic-controlled counterparts.[361]

Second, the Treasury earnings stripping report compares the ratios of "operating income" to total receipts for foreign-controlled domestic corporations to the corresponding ratios for domestic-controlled corporations. Operating income is defined as net income plus interest expense and depreciation and similar items, and minus interest income, dividends, and royalties received. The Treasury earnings stripping report finds that, after adjusting for these items, foreign-controlled domestic corporations are generally more profitable than their domestic-controlled counterparts.[362] The data in this part of the study show that domestic-controlled corporations have greater interest expense as a proportion of total receipts than do foreign-controlled domestic corporations.[363]

It is unclear whether these findings with respect to profitability tend to support or refute the proposition that foreign-controlled domestic corporations engage in earnings stripping. Some might argue that even if the findings with respect to operating income suggest that foreign-controlled domestic corporations in the nonfinancial and, more specifically, the manufacturing

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[361] Treasury earnings stripping report, at 13. These analyses were separately performed for the nonfinancial, manufacturing, and financial sectors.

[362] Treasury earnings stripping report, at 15-16. These analyses were separately performed for the nonfinancial and manufacturing sectors. The Treasury earnings stripping report's measure of operating income is reduced by non-interest expenses, such as research and experimentation, stewardship, and State and local taxes, that the taxpayer must allocate or apportion to foreign-source income for foreign tax credit purposes. Because by definition the foreign-source income associated with these expenses is generally excluded from operating income, adding back such expenses may provide the basis for a more valid comparison between foreign-controlled domestic corporations and domestic-controlled corporations.

[363] *See* Treasury earnings stripping report, Table 2.2, at 15. This data, particularly the lines showing the ratio of interest paid to total receipts, may suggest that foreign-controlled domestic corporations are not engaged in earnings stripping. However, it should be noted that it would be possible for a domestic-controlled corporation and a foreign-controlled domestic corporation to have similar interest expense burdens but have dissimilar reasons underlying their equivalent burdens. For example, a domestic-controlled corporation is more likely than a foreign-controlled domestic corporation to incur significant interest expense in the United States that may be linked (or, in technical terms of the Code, allocable or apportionable) to foreign source income (and such income may be currently includible in U.S. taxable income or deferred), reflecting that foreign-controlled domestic corporations are more likely to incur interest expense solely for the purpose of financing economic activity conducted in the United States, while domestic-controlled corporations often incur interest expense in connection with the financing of both domestic and foreign entities in the overall corporate group. The same data issue may exist with respect to the interest expense and cash flow analysis set forth in Table 2.3 of the Treasury earnings stripping report, at 18.

sectors are more profitable than comparable domestic-controlled corporations before interest income and expense (and other non-operating items) are taken into account, the data presented do not identify how much of the interest income is received from, and interest expense is paid to, foreign-related parties, and therefore, it is difficult to conclude that foreign-controlled domestic corporations are engaging in earnings stripping rather than utilizing third-party debt.[364]

Third, the Treasury earnings stripping report analyzes the relationship between interest expense and cash flow.[365] The report determines that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestic-controlled corporations. The report also determines that foreign-controlled domestic corporations in these sectors are less likely to be above the section 163(j) threshold of 50 percent of adjusted taxable income than are comparable domestic-controlled corporations.[366] In the financial sector, the report determines that foreign-controlled domestic corporations in some industries appear to have significantly higher interest expense relative to cash flow than their domestic-controlled counterparts. However, the Treasury earnings stripping report states that "the comparison is not completely unambiguous and it is difficult to draw firm conclusions from the data because of the possibility of alternative explanations and the problems with using domestic-controlled corporations as a comparison group."[367]

Thus, the Treasury earnings stripping report concludes that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[368] and that it is not possible to determine with precision whether section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.[369] The Treasury Department recommends gathering additional information from taxpayers relating to earnings stripping in order to determine whether it would be appropriate to modify the proposal with respect to foreign-controlled domestic corporations. Accordingly, on November 28, 2007, the Treasury Department and the IRS issued a proposed tax form, Form 8926, *Disqualified Corporate Interest*

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[364] Unfortunately, the Treasury earnings stripping report does not analyze the data from Form 5472 regarding interest payments from foreign-controlled domestic corporations to their foreign owners (i.e., disqualified interest). That analysis might have shed some light on the extent of any earnings stripping.

[365] The numerator, interest paid, used by Treasury in Table 2.3 of the Treasury earnings stripping report (at 18) takes into account interest expense linked to deferred income (both foreign- and domestic-source income), while neither cash flow nor total receipts, the alternative denominators, reflects this deferral. This asymmetry may affect the comparison of results for foreign-controlled domestic corporations and domestic-controlled corporations.

[366] Treasury earnings stripping report, at 19.

[367] Treasury earnings stripping report, at 21.

[368] Treasury earnings stripping report, at 25.

[369] Treasury earnings stripping report, at 26.

Expense Disallowed under Section 163(j) and Related Information, to gather additional information from corporate taxpayers relating to the determinations and computations under section 163(j).[370]

Discussion of wider points raised by Treasury earnings stripping report

Effects of debt financing

A foreign corporation has the option of financing its U.S. subsidiaries through equity or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing, even if not rising to the level of earnings stripping, may facilitate lowering the rate of U.S. tax on the U.S. operations. Moreover, even if the full 30-percent U.S. withholding tax is imposed upon the interest payment, there remains a 5-percent taxpayer-favorable difference, if the interest expense is deductible at the highest U.S. corporate rate of 35 percent. In addition, the interest recipient may be able to take a credit for the U.S. withholding tax, in whole or in part, against its tax in the applicable foreign country, or the interest may be tax-exempt in such country. Although a foreign tax credit might also be available for withheld taxes on a dividend and the underlying U.S. corporate tax, in general there is a greater possibility of double taxation in the case of dividends paid by foreign-controlled domestic corporations to their parents than in the case of interest. Moreover, debt principal may be repaid on a tax-free basis, while redemption of equity by a foreign parent is generally treated as a dividend distribution unless the corporation paying the dividend has no earnings and profits.[371]

Studies have determined that, with some exceptions, greater investment is linked to overall higher labor compensation.[372] The Treasury earnings stripping report suggests that income shifting may support increased investment into high-tax jurisdictions (such as the United States) by lowering the effective tax rate.[373] Whether the ability of U.S. businesses to pay

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[370] Proposed Form 8926 has been issued in draft form and is available on the IRS website at http://www.irs.gov/pub/irs-dft/f8926--dft.pdf. See also Announcement 2007-114, 2007-50 I.R.B. 1176. In August 2006, the Staff of the Joint Committee on Taxation presented to then-Chairman Grassley and Ranking Member Baucus of the Senate Finance Committee a report that includes a proposal to gather taxpayer information relating to the operation of section 163(j), similar to that of proposed Form 8926. See Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*, August 3, 2006, at 41-43 (released by Senate Finance Committee on October 19, 2006 and available on Senate Finance Committee website at http://finance.senate.gov/press/Gpress/2005/prg101906.pdf).

[371] *See* secs. 301 and 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. *See* sec. 302(b).

[372] Recent references to this linkage include the Congressional Research Service, *Tax Treaty Legislation in the 110th Congress: Explanation and Economic Analysis*, (CRS/RL34245, January 2008) at 8.

[373] Treasury earnings stripping report, at 24. Existing empirical research does not address this question. *Id*. The linkage between foreign investment and labor compensation requires that a number of

interest to related foreign debt-holders should be further abated may be part of a larger policy discussion that balances revenue and other needs in an international context. It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. However, the best way to encourage increased investment in the United States (by foreign or domestic investors) is to lower the general cost of capital, and that reduction is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as the facilitation of earnings stripping.

Earnings stripping and tax treaties

As noted in the Present Law section, earnings stripping generally provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures, and if that country has entered into a tax treaty with the United States that provides a reduced U.S. withholding tax rate on interest.

Thus, the applicable foreign tax rate and the U.S. withholding tax rate on the interest payment are two factors that impact the ability of foreign-controlled domestic corporations to effectively engage in earnings stripping. These two factors are interrelated. While a low foreign tax rate relative to the U.S. rate is critical to effective earnings stripping, if the general foreign tax rate is zero, it is not likely that the United States would now enter into a tax treaty with that foreign country that lowers the U.S. withholding tax rate on interest.[374] Therefore, such a foreign corporation may attempt to utilize a U.S. tax treaty with another foreign county in order to obtain a lower U.S. withholding tax rate. This practice is known as treaty shopping.[375]

As described in detail in its Study of Income Tax Treaties issued with the Treasury earnings stripping report, the Treasury Department has taken significant steps since 2000 to

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things be held constant - for example, that any potential loss of revenue associated with income shifting not also "crowd out" investment in the United States by either domestic or foreign investors.

[374] The United States has, however, some older tax treaties with foreign countries, for example Iceland and Hungary, that offer tax incentives or special regimes that may permit taxpayers to reduce or avoid taxes on interest payments. The Study of Income Tax Treaties states that a number of these incentives or special regimes, including in Iceland and Hungary, have been repealed, are phasing out, or are scheduled to terminate. See Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 28, 2007, at 83 and n.89.

[375] Treaty shopping is not limited to withholding on interest payments. A person may engage in treaty shopping to obtain other benefits under a U.S. tax treaty, for example, to lower withholding on royalty or dividend payments, or to exempt income from a U.S. trade or business that is not attributable to a permanent establishment in the United States.

combat treaty shopping by negotiating new and stricter limitation-on-benefit ("LOB") provisions with several U.S. treaty partners, as well as including a similar new LOB provision in the United States Model Income Tax Convention of November 15, 2006. These stricter LOB provisions include a series of complex objective tests to determine whether a resident of a treaty country is sufficiently connected economically to that country to warrant receiving treaty benefits.[376]

As noted in the Study of Income Tax Treaties, there are several older U.S. tax treaties with no LOB provision - Greece (1953), Hungary (1979), Iceland (1975), Pakistan (1959), the Philippines (1982), Poland (1976), Romania (1976), and the U.S.S.R. (1976).[377] The Study of Income Tax Treaties further notes that, "[o]f these, zero-rate withholding provisions on interest in the treaties with Iceland, Poland, and Hungary make those the most attractive treaty shopping candidates."[378] These same characteristics make those countries very attractive earnings stripping candidates as well.[379]

The Treasury Department has stated that in its continuing review of the current U.S. tax-treaty network to identify deficiencies in existing agreements and areas where more beneficial terms for U.S. taxpayers could be negotiated, anti-treaty-shopping provisions are given special scrutiny to ensure that they are functioning appropriately. Treaties with LOB provisions that are out of date or need strengthening are given higher priority in the plan for negotiations.[380] As the Treasury Department further updates current treaties to add missing LOB provisions and to strengthen weaker LOB provisions, opportunities for foreign-controlled domestic corporations to engage in earnings stripping will decrease, but will not disappear entirely. Some argue that a

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[376] *See* Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 28, 2007, at 78-82. The recent U.S. treaties and protocols that include these strengthened LOB provisions include, for example, those with Belgium (treaty entered into force on December 28, 2007); Germany (protocol entered into force on December 28, 2007); the Netherlands (protocol entered into force on December 28, 2004); and Barbados (protocol entered into force on December 20, 2004).

[377] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 28, 2007, at 82. In addition, there are other tax treaties in the U.S. treaty network that include older and weaker LOB provisions which may be circumvented.

[378] *Id*. A new tax treaty between the United States and Iceland that includes an LOB provision similar to that in recent U.S. treaties was signed in October 2007.

[379] Tables 4.1 and 4.3 of the Study of Income Tax Treaties provide information on the amounts of interest paid by foreign-controlled domestic corporations in 1996 and 2004, respectively, to related parties resident in foreign countries. Between these two dates, the amounts of interest paid to residents of Hungary, Iceland, and Switzerland increased dramatically. The average amounts of interest paid in 2004 to foreign-related parties in these countries appear to be higher than most of the other countries. In addition, corporations in Luxembourg received relatively large amounts of foreign-related party interest, in both absolute and average terms. *Id*. at 84 (Table 4.1) and 86 (Table 4.3).

[380] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 28, 2007, at 88.

vigorous anti-treaty-shopping regime should be sufficient to address the most serious cases of earnings stripping, and that specific legislation targeting earnings stripping is not necessary. Others assert that strengthening the existing rules targeting earnings stripping (i.e., 163(j)) is the most direct means to curtail earnings stripping.

Limitation of the scope of the proposal to inversions

Section 7874 appears to have eliminated the opportunity for domestic-controlled corporations to engage in earnings stripping by engaging in new inversion transactions.[381] However, both incentive and opportunity remain for foreign-controlled domestic corporations and corporations that inverted on or before March 4, 2003 to engage in earnings stripping. The proposal would further restrict earnings stripping for that category of inverters,[382] but not for the much larger group of foreign-controlled domestic corporations.

Although recent legislative and treaty developments have removed some significant opportunities for earnings stripping, and notwithstanding that the Treasury earnings stripping report does not conclusively determine that foreign-controlled domestic corporations that are not expatriated entities are engaging in earnings stripping, some argue that, as a matter of tax policy, the earnings stripping rules should treat foreign-controlled domestic corporations in the same manner as expatriated entities because both types of corporations have the same incentives and capabilities to erode the U.S. tax base, and may do so in the same manner. Proponents of this argument observe that it should not be surprising that the available information clearly demonstrates that expatriated entities are engaging in earnings stripping because expatriated entities comprise an easily-identifiable subclass of foreign-controlled domestic corporations and have demonstrated a propensity for aggressive tax planning. Proponents of stricter across-the-board earnings stripping rules also argue that there is sufficient evidence of earnings stripping to justify implementing such a regime, and that significant erosion of the U.S. tax base will continue until the earnings stripping rules are strengthened for all foreign-controlled domestic corporations.

Others agree with the conclusion of the Treasury earnings stripping report that there is insufficient evidence to justify legislative action outside the context of inversions at this time, and that it would be more prudent to await the receipt and analysis of taxpayer data on earnings stripping submitted through the new Form 8926. Proponents of this view may also believe that the implementation of the new form should increase compliance with section 163(j). In response, some argue that it will be at least several years before careful analyses can be performed on any data submitted through Form 8926, and that there is currently sufficient concern and anecdotal evidence regarding earnings stripping by foreign-controlled domestic

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[381] The Treasury earnings stripping report (at 3) states, "[s]ection 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations."

[382] Some might argue that it is unfair to effectively impose additional taxes upon corporations on the basis of transactions occurring in part prior to the time the transactions were addressed by the Code. However, the proposal would be effective only with respect to payments made on or after the date of enactment. Therefore, it is not retroactive in effect.

corporations to justify strengthening the substantive earnings-stripping rules now, while continuing to analyze data as it becomes available.

Other types of earnings stripping

Still others argue that the proposal does not go far enough in curtailing earnings stripping by means other than deductible interest. The proposal does not address earnings stripping transactions involving the payment of deductible amounts (by expatriated entities or foreign-controlled domestic corporations) other than interest (e.g., rents, royalties, reinsurance premiums, and service fees), or the payment of deductible amounts by taxpayers other than corporations. These transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to earnings stripping is needed. The Treasury Department's examination of payments declared on Form 5472 by seven expatriated entities suggests that, although the majority of earnings stripping by expatriated entities is through interest, some earnings stripping occurs through royalties.[383] Indeed, as opportunities for stripping earnings in the form of interest are reduced, taxpayers may find it increasingly attractive to strip earnings through other means. Some respond to this argument that earnings stripping is much more readily achieved through the use of debt than through other means,[384] and that there is insufficient evidence to suggest that these other forms of stripping warrant a new legislative response.

Prior Action

The President's fiscal year 2005, 2006, 2007, and 2008 budget proposals contained an earnings stripping proposal similar to the proposal in the 2009 budget except that it would have applied regardless of whether an inversion had occurred. The President's fiscal year 2004 budget proposal contained a different earnings stripping proposal that would have modified the safe harbor provision, reduced the adjusted taxable income threshold, added a new disallowance provision based on a comparison of domestic to worldwide indebtedness, and limited carryovers.

In 2007, the House passed a provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign-related party may not be less than the amount which would be imposed if the payment were made directly to its foreign parent corporation.[385] Later in 2007, the Chairman of the Committee on Ways and Means introduced a provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign-related party may not be reduced under a U.S. treaty unless such withholding

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[383] Treasury earnings stripping report, at 22.

[384] The Treasury Department notes that loading up a foreign-controlled domestic corporation with a disproportionate amount of debt in order to engage in earnings stripping does not generally require any real movement of assets or a change in the business operations of the corporation. In contrast, the use of royalties or other deductible payments may result in a change in tax position but also may require a real change in business operations. See Treasury earnings stripping report, at 7 & n.1.

[385] H.R. 2419, sec. 12001 (2007).

tax would be reduced under a U.S. treaty if such payment were made directly to the foreign parent corporation.[386] Both of these provisions would apply to all deductible payments to foreign-related parties, and not solely to interest.

In 2006, the Senate passed a provision applicable to certain expatriated entities that would have eliminated the safe harbor and reduced the present-law threshold of 50 percent of adjusted taxable income to 25 percent for both net interest expense and excess limitation.[387]

There were also three pre-AJCA legislative proposals relating to earnings stripping. In 2004, the Senate passed a provision that would have tightened the interest stripping rules for corporations that had engaged in certain inversions. For these corporations, the proposal would have eliminated the debt-to-equity safe harbor, reduced the threshold for excess interest expense to 25 percent of adjusted taxable income, and modified the excess limitation threshold so that 25 percent of adjusted taxable income over a corporation's net interest expense for a year could be carried forward three years.[388]

A 2003 Senate proposal provided a special exception for any corporation that was subject to the earnings stripping rules as a result of a related-party guarantee if the taxpayer could establish to the satisfaction of the Secretary of the Treasury that it could borrow a substantially similar amount of money without the guarantee.[389]

A 2002 House proposal would have strengthened the earnings stripping rules regardless of whether the corporation entered into an inversion transaction. The proposal would have eliminated the debt-to-equity safe harbor and would have reduced the threshold for excess interest expense from 50 percent to 35 percent of adjusted taxable income. Disallowed interest could be carried over for five years, but excess limitation could not be carried over. The proposal added an additional rule that would generally disallow related-party interest expense to the extent that the U.S. subsidiaries of a foreign parent were more highly leveraged than the overall worldwide corporate group. Disallowed interest and excess limitation could not be carried forward. The amount of total interest expense disallowed would be the greater of the current-law disallowance rule as modified by the proposal, or the additional interest-disallowance rule.

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[386] H.R. 3970, sec. 3204 (2007).

[387] H.R. 4297, sec. 441 (2006). See H.R. Rep. No. 109-455, at 245-50 (2006).

[388] S. 1637, sec. 441(d)(2) (2004).

[389] S. 1475, sec. 255 (2003).

I. Repeal Excise Tax on Communications Services

Present Law

The Code imposes a three-percent Federal excise tax on amounts paid for communications services. Communications services are defined as "local telephone service," "toll telephone service," and "teletypewriter exchange service."[390] The person paying for the service (i.e., the consumer) is liable for payment of the tax. Service providers are required to collect the tax; however, if a consumer refuses to pay, the service provider is not liable for the tax and is not subject to penalty for failure to collect if reasonable efforts to collect have been made. Instead, the service provider must report the delinquent consumer's name and address to the IRS, which then must attempt to collect the tax.[391]

Local telephone service is defined as the provision of voice-quality telephone access to a local telephone system that provides access to substantially all persons having telephone stations constituting a part of the local system.[392]

Toll telephone service (which is essentially long distance telephone service) is defined as voice quality communication for which (1) there is a toll charge that varies with the distance and elapsed transmission time of each individual call and payment for which occurs in the United States, or (2) a service (such as a wide area telephone service, or "WATS") which, for a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), entitles the subscriber to an unlimited number of telephone calls to or from an area outside the subscriber's local system area.

Until August 1, 2006, telephone companies collected excise tax on toll telephone service even if the toll charge on such service did not vary with both distance and elapsed transmission time. However, in several cases, the Courts of Appeals held that the Federal excise tax on communications services does not apply to long distance (i.e., toll telephone) services sold at flat per-minute rates for interstate, intrastate, and international calls. The courts concluded that the excise tax does not apply because a flat per-minute rate does not vary with both distance and

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[390] Sec. 4251. "Teletypewriter exchange service" refers to a data system that provides access from a teletypewriter or other data station to a teletypewriter exchange system and the privilege of intercommunication by that station with substantially all persons having teletypewriter or other data stations in the same exchange system. Sec. 4252(c). While it is understood that the system to which the definition was initially intended to apply is no longer in use, the definition may fit other services provided now or that may be provided in the future.

[391] In general, the amount of tax is based on the sum of charges for taxable services included in the bill. If the person who renders the bill groups individual items for purposes of rendering the bill and computing the tax, then the tax base with respect to each such group is the sum of all items within that group. The tax on any remaining items not included in any such group is based on the charge for each item separately. Sec. 4254(a).

[392] The access to substantially all persons having telephone stations constituting a part of the local system is sometimes referred to as access to the public switched telephone network.

transmission time as required by the statute.[393] In response to these court decisions, the IRS issued Notice 2006-50, directing telephone companies to cease collecting and paying over tax on long distance services and bundled services billed after July 31, 2006.[394] In Notice 2006-50, the IRS also announced a program to refund approximately $13 billion in excise taxes on long distance and bundled services. The Federal excise tax on local-only telephone service remains in effect.[395]

Description of Proposal

The proposal repeals the excise tax on communications services in its entirety.

Effective date.–The proposal applies to amounts paid pursuant to bills first rendered more than 90 days after the date of enactment.

Analysis

Proponents of repealing the communications excise tax in its entirety assert that the burden of the remaining excise tax on purely local communications services will be borne primarily by the poor and the elderly as purely local telephone service is replaced over time by nontaxable cellular service and other bundled services. Proponents of restoring and retaining the communications excise tax in its entirety assert that it would be relatively simple to amend the current statute to address the long distance issue and to raise revenues, for example, by applying the excise tax to charges for long distance and bundled services regardless of whether those charges are fixed or vary with distance, elapsed transmission time, both, or some other criteria.[396]

Prior Action

An identical proposal was included in the President's fiscal year 2008 budget proposal. A similar proposal is included in S. 140, S. 170, and H.R. 1194, of the 110th Congress. A similar provision was included in the "Telephone Excise Tax Repeal and Taxpayer Protection and

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[393] *See, e.g.*, *Reese Bros. v. United States*, 97 AFTR 2d 2006-2393 (3d Cir. 2006); *Fortis v. United States*, 97 AFTR 2d 2006-2228 (2d Cir. 2006); *American Bankers Insurance Group v. United States*, 408 F.3d 1328 (11th Cir. 2005); *Office Max, Inc. v. United States*, 428 F.3d 583 (6th Cir. 2005); *Nat'l R.R. Passenger Corp. v. United States*, 431 F.3d 374 (D.C. Cir. 2005).

[394] Notice 2006-50, 2006-1 C.B. 1141 (May 26, 2006), *amplified, clarified, and modified by* Notice 2007-11, 2007-5 I.R.B. 405 (Dec. 28, 2006). Notice 2006-50 defines long distance services as "telephonic quality communications with persons whose telephones are outside the local telephone system of the caller." Bundled services are defined as "local and long distance services provided under a plan that does not separately state the charge for the local telephone services." In general, bundled services include cellular phone services.

[395] For an overview of the history of the communications excise tax, *see* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, (JCS-02-05), at 368, 371.

[396] *See, e.g.*, *id.* at 368, 373.

Assistance Act of 2006," as reported by the Senate Finance Committee.[397] A similar provision was also passed by the Congress in a legislative appropriations bill that was vetoed by the President in 2000.[398]

[397] S. Rep. No. 109-336, at 5-7 (2006).

[398] H.R. 4516, 106th Cong., 2d Sess. (2000).

J. Modify Financing of the Airport and Airway Trust Fund

Present Law

Excise taxes are imposed on commercial air passenger and freight transportation, and on fuels used in both commercial and noncommercial aviation to fund the Airport and Airway Trust Fund. The Airport and Airway Trust Fund was established in 1970 to finance a portion of the costs of the Federal Aviation Administration ("FAA") services and grant programs for airports.

The current Airport and Airway Trust fund excise taxes on commercial aviation include:

(1) a 7.5 percent tax plus a $3.50 segment tax on domestic air passenger transportation,

(2) a $15.40 tax on each international arrival or departure, and

(3) a 6.25 percent tax on domestic air freight.

In addition, aviation fuel used in commercial aviation is subject to a tax of 4.3 cents per gallon. Kerosene (jet fuel) used in noncommercial aviation is subject to a tax of 21.8 cents per gallon and aviation gasoline is taxed at 19.3 cents per gallon.[399]

The Airport and Airway Trust Fund taxes are scheduled to expire on June 30, 2008, with the exception of 4.3 cents of the fuel tax rates, which is permanent. The authority to make expenditures from the Airport and Airway Trust Fund also expires on June 30, 2008.

Description of Proposal

The taxes on air transportation and aviation fuel would be extended through September 30, 2009, at their current rates. Beginning October 1, 2009, the FAA would collect user fees for air traffic control services provided to commercial aviation.

The aviation fuel taxes would be modified and extended through September 30, 2018. The tax on aviation fuel would be 13.6 cents per gallon for kerosene used in commercial aviation, 69.6 cents per gallon for kerosene used in noncommercial aviation, and 69.6 cents for aviation gasoline. Beginning October 1, 2012, the rate of tax on aviation fuel would be regularly adjusted as necessary to maintain the relationship between the fuel tax collections and the costs of the FAA programs those taxes support.

Expenditure authority for the Airport and Airway Trust fund would be extended through September 30, 2018.

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

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[399] Aviation fuels are also subject to a 0.1 cent per gallon tax which is dedicated to the Leaking Underground Storage Tank Trust Fund.

Analysis

Criteria for assessing transportation excise taxes

Cost allocation or recovery of costs is one factor that policymakers examine when determining the merits of undertaking certain transportation infrastructure projects or when contemplating imposing excise taxes on the transportation industry. Analysts generally judge a tax more broadly in terms of efficiency, equity, and administrability. Efficiency involves an assessment regarding the benefit or well being received from the utilization of scarce resources. Policies that distort consumer choice generally are said to reduce society's well being. Equity involves an assessment of the "fairness" of a tax. Generally two standards are applied: horizontal equity and vertical equity. Horizontal equity involves whether equivalently situated individuals are treated equivalently. Vertical equity involves the extent to which individuals in different economic circumstances, generally measured in terms of individual well being, are treated differently. Administrability involves an assessment of the expense to the Government and the taxpayer of collecting the tax imposed. In evaluating tax proposals, tradeoffs must be made among the three goals. Rarely is a tax that is deemed most equitable the most efficient or most administrable tax. Likewise the most administrable tax may not be the most efficient or most equitable. The discussion below separately considers general issues of efficiency and equity that may be relevant in analyzing the President's proposal.

Efficiency and transportation excise taxes

Economists generally conclude that private market outcomes constitute efficient outcomes--that is, private market outcomes create the greatest amount of benefit compared to the resources used. This conclusion may be described briefly as follows. In a free market, individuals will seek to purchase those goods that they value most highly. But, they will purchase any given good only if they think the benefit the good will produce for them equals or exceeds the price they must pay to obtain the good. Likewise, suppliers of goods will supply goods as long as the price received from the buyer equals or exceeds the cost of supplying an additional unit of the good. Thus, those goods purchased represent the bundle of goods producing the greatest overall benefit relative to the costs expended to produce the goods. Following this line of reasoning, economists argue that efficiency is always increased as long as the price paid (or benefit received) for an additional unit of a good exceeds the incremental, or marginal, resource cost of producing the good. Conversely, efficiency is decreased whenever the price paid (or benefit received) for an additional unit of a good is less than the marginal resource cost of producing the additional unit of the good.[400]

The benefit principle, transportation excise taxes, and efficiency

While all taxes finance benefits (i.e., pay for Government services), the incidence of particular taxes often is only loosely related to any benefits received from government services.

[400] For a more detailed discussion of economic efficiency in the provision of transportation services, see, Congressional Budget Office, *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992.

Government provision of air transportation services, however, is different from the provision of many other services. It is possible to exclude many citizens from the use of air transportation services. For example, generally licensed pilots and ticketed passengers on commercial airlines may use air traffic control services, while all citizens, without exclusion, enjoy the benefits of the national defense. This distinction makes the provision of air transportation services somewhat like the provision of other goods and services by the private market for which prices are charged.[401] Some people view the Airport and Airway Trust Fund excise taxes as payments for the provision of specific services (air traffic control) much as the fees collected at highway toll booths pay for the construction and maintenance of specific toll roads. Some argue that it is appropriate to tie certain Government services or expenditures to specific tax revenues, under what is sometimes referred to as the "benefit principle," of taxation.[402] Such taxes are often referred to as "benefit taxes." The tax is viewed as the price one must pay for the service. For example, to fly from New York to Washington one must buy a ticket and that means one must pay the present-law ticket prices. When a tax is collected in return for a service provided, the efficiency standard remains unchanged. The tax generally would be viewed as promoting the efficient use of society's resources as long as the tax paid for an additional unit of the air transportation service equals or exceeds the incremental, or marginal, resource cost of producing the additional units of air transportation service.

As a practical matter, it would be difficult design and administer a pure benefit tax. Such a tax theoretically may require a different tax payment by each individual. Determining the correct payment and administering such a system would be costly. Moreover, many would view such taxes as unfair because two seemingly similar taxpayers may be asked to pay different amounts of tax. On the other hand, simplification may dilute some of the efficiency advantages of a theoretical benefit tax.

Marginal cost pricing, transportation excise taxes, and economic efficiency

An alternative way to achieve an economically efficient outcome is to set the price charged to users of a service equal to the marginal cost of providing that service to the individual user. As explained above, consumers compare the price of a service with the benefit they anticipate from receiving an additional unit of service. If the price exceeds the benefit, consumers will not use the additional service, or will decrease their use. On the production side, if consumers are charged less than the marginal cost of providing the service, they may be encouraged to overuse the service. Total welfare declines as costs exceed the benefits provided. If consumers are charged more than the marginal cost of providing the service, they may be discouraged from using the service. Total welfare could increase by further provision of the service because further use would produce benefits that exceed costs. When price equals

[401] There are reasons that might lead to the conclusion that the private market would not provide transportation or other services, even if it were possible to exclude certain users and charge individual prices. See the discussion of economies of scale below.

[402] The benefit principle has long been advanced as a standard of equity and is discussed more in that context below.

marginal cost there is neither overuse nor underutilization and society's resources are used efficiently.

The conclusion that efficiency results when users are asked to pay the marginal cost of providing the service is not the same as saying the user should pay the average cost of provision of the service. Thus, setting taxes by average cost generally will not lead to an efficient allocation of resources. Many cost allocation studies emphasize the average cost of services and make little attempt to measure the marginal cost of services.

The conclusion that marginal cost pricing produces an efficient outcome may appear contradictory with the previous discussion that benefit taxation could produce an efficient outcome. The previous discussion suggested that an outcome could be efficient if each user were charged his or her marginal benefit so long as that benefit exceeded the incremental, or marginal, cost of providing the service. The difference between that standard and the standard currently under discussion involves whether consumers of the service pay the full value of the benefit they receive or whether they pay the marginal cost of producing that benefit. When consumers pay only for the marginal cost of producing that benefit, there generally is value to the consumer beyond the value of the resources used to produce the benefit. When consumers pay the full value of the incremental benefit they receive, the provider receives as incremental profit that value of the benefit that exceeds the marginal cost of producing the service. Thus, the difference between the two efficient outcomes involves whether consumers retain the value of benefit in excess of cost or whether consumers pay that value of benefit in excess of cost over to the producer of the service.[403]

If the transportation excise taxes were imposed at levels that represented the incremental resource cost incurred for providing transportation services to each taxpayer, then the taxes could be called "economically efficient." However, in choosing a tax rate that equals a user's marginal cost, a question arises as to whether policy makers should look at short run marginal costs or long run marginal costs. Generally, short run marginal costs would reflect resource costs when investment is fixed and long run marginal costs would reflect resource costs assuming the level of capital investment can vary. That is, in the case of airports and airways, short run marginal costs would involve the costs of maintenance and operation of the existing air traffic control system (e.g., the wages of air traffic controllers), while long run resource costs would involve costs such as those associated with bringing a new nationwide radar system on line.

Marginal costs often will vary for provision of services to different taxpayers. For example, certain airports suffer worse weather than others and may require additional costs to maintain operations. Imposing a tax to recoup marginal costs would imply differential taxes for users of different airports. Such a tax may violate the uniformity clause of the Constitution, but, even if it did not, a tax system with different rates of tax for many different users would be more

[403] Economists call the benefit a consumer receives in excess of the price he or she must pay the "consumer surplus." Likewise, economists call the revenue a producer receives in excess of the marginal cost of producing a good or service the "producer surplus." Thus, the difference between the two efficient pricing structures may be described as whether the consumer surplus is transferred to the producer.

complex and more costly to administer than the current transportation excise taxes. In practice, it may be difficult to discern marginal costs. Moreover, some might argue that such taxes are unfair, in that they impose different burdens on otherwise similarly situated taxpayers. Modifications to address concerns of administrability and fairness may dilute the gains of economic efficiency that economists argue flow from marginal cost pricing. If a modification took the form of charging all air passengers the average cost of providing air traffic control services, some taxpayers might pay a tax greater than their marginal cost (implying inefficient underutilization of resources) and other taxpayers may pay a tax less than their marginal cost (implying inefficient overutilization of resources). Design of air transportation excise taxes to incorporate the efficiency properties of marginal cost pricing involves tradeoffs between the goals of efficiency, equity, and administrability.

Cost allocation and air transportation efficiency

Cost allocation as a basis of transportation excise tax design also may create an economically inefficient tax structure. The provision of transportation services often requires substantial capital investments. Fixed costs tend to be large compared with marginal costs. For example, the construction of a major new parallel runway at a hub airport requires a substantial fixed capital investment. The additional resource cost (wear and tear) imposed by one additional plane landing on the runway, once the runway has been built, is quite small in comparison. This means that the provision of many transportation services is often characterized by "economies of scale." Provision of a good or service is said to be characterized by economies of scale when the average cost of providing the good or service exceeds the marginal cost of providing that good or service. When this occurs, the average cost of providing the good or service is falling with each additional unit of the good or service provided. As discussed above, economists recommend setting prices or taxes equal to marginal cost to obtain economically efficient outcomes. However, in the presence of substantial economies of scale, the marginal cost is less than the average cost of providing the transportation service and the revenues collected from equating taxes to marginal costs would not cover the full expenditure required to provide the service. That is, provision of the service may require a subsidy beyond the revenues provided by the economically efficient tax.[404]

On the other hand, advocates of cost allocation would set the price or taxes for transportation services at rates equal to the average cost of services. In the presence of substantial economics of scale, average cost pricing implies that consumers are being charged prices in excess of marginal resource costs and that less than the economically efficient level of air transportation services are provided. Indeed, an expansion of services would lead to a decline in the average cost of the service to each user. If each user could be charged that lower average price, the price paid would still exceed the marginal cost of the provision of the service, all costs

[404] Some argue that the presence of economies of scale justify Government involvement in certain infrastructure investments. They argue that when the economies of scale are great, the potential for cost recovery and profit from market prices may be insufficient for private providers to undertake the investment, even though provision of the service would create marginal benefits that exceed marginal costs.

would be recovered and net economic well being (efficiency) would increase. Charging a lower average price, however, would not permit full cost recovery. Thus, the principle of cost allocation involves a trade off between economic efficiency and cost recovery.

Equity and transportation excise taxes

Equity involves an assessment of the "fairness" of a tax. To determine fairness it is necessary to look beyond the statutory incidence of a tax to its economic incidence, or market effect. Generally, two standards are applied: horizontal equity and vertical equity. In addition, some suggest that the benefit principle as an equitable basis of taxation and others suggest cost recovery or cost allocation as an equitable basis of taxation.

Horizontal equity and air transportation excise taxes

Horizontal equity looks to whether equivalently situated individuals are treated equivalently. An issue in applying the notion of horizontal equity in the context of air transportation excise taxes is how broadly to interpret the concept of "equivalently situated individuals." For example, one could argue that the current excise tax on jet fuel is horizontally equitable because all providers of commercial air transportation by jet pay the same rate of tax per gallon of jet fuel. Alternatively, one might argue that the current excise tax is horizontally inequitable because those taxpayers providing air transportation services with modern, more fuel efficient equipment pay less tax per mile of air service provided than do those taxpayers providing air transportation services with less fuel efficient equipment. This analysis would change to the extent one views the economic incidence as on the passengers.

Vertical equity and air transportation excise taxes

Vertical equity involves the extent to which individuals in different economic circumstances, frequently measured by reference to individuals' incomes or other measures of economic well being, are treated differently. It may not be appropriate to place undue emphasis on the vertical equity of any one tax or group of taxes that are part of a larger tax system. The importance of the vertical equity of any specific tax is by that tax's marginal effect on the vertical equity of the entire tax system. If the use of air transportation services is a larger share of the consumption expenditures of lower income individuals than of higher income expenditures, the air transportation excise taxes, which tend to be proportional to the use of transportation services, would be considered to be regressive. That is, while the total amount of air transportation taxes paid may rise as individuals' incomes rise, the taxes as a proportion of income fall.

While it is possible to conceive of a system of transportation taxes in which the tax burden does not decline as income increases, such a system generally would require more information than is needed under the current tax collection system at the point of imposition. Any system that relies on characteristics of individual taxpayers generally will be administratively more complex and prone to evasion than one that treats all purchasers identically regardless of individual characteristics.

The benefit principle and transportation excise tax equity

According to the benefit principle, an equitable tax system is one under which each taxpayer contributes commensurately with the benefits which he or she receives from the public services provided. Unlike the principles of horizontal equity or vertical equity, but like the notion of cost allocation discussed below, the benefit principle directly links tax and expenditure policy in an assessment of equity. Many analysts see several of the current Trust Fund excise taxes as examples of the benefit principle. However, these taxes only satisfy the benefit principle notion of equity in a rough way. For example, while jet fuel use depends on distances flown, generally each mile flown does not result in the same benefit, nor the same benefit for each air passenger. The New York - Washington air corridor may have a greater benefit to a business traveler during Monday through Friday than for the same travel visiting a friend on the weekend, while the jet fuel consumed, and tax paid, would vary with the type of plane servicing the route and with the air traffic conditions. Moreover, expenditure decisions are made for specific outlays, while present-law taxes are paid independently of particular services provided, so there may be no direct linkage between the specific benefit received and the tax imposed. For example, all air travelers would pay taxes that finance an upgrade of air traffic control facilities in the Northeast, even though many air travelers fly only within West Coast air corridors. Attempts to apply the benefit principle to taxation in a more precise fashion often would involve creating a more complex administrative structure in an attempt to account for benefit differences across individual taxpayers. The benefit principle may be more readily applied with respect to project specific fees.

Cost allocation and transportation excise taxes

Some analysts suggest that when looking at a joint financing and expenditure program, a fair way to assess the financing burden is not by the benefit received, but by allocating to each user a share of the expenditures related to the average costs that user imposes on the service. Such an approach attempts to allocate to each user, or class of users, the expenditures incurred that may be reasonably attributed to that user. Although such a tax system for air transportation may place the burden of financing the system on the users of the system, as was discussed in the context of the benefit principle above, it may not fully meet the equity objective because it allocates costs to each individual user of the transportation service in only a rough fashion. Reliance on broad averages may obscure substantial differences among different users within a broad user class.

Issues raised by the budget proposal

The present excise taxes generally have been in place in similar forms since the creation of the Airport and Airway Trust Fund in 1970. Prior to that time, General Fund financing and appropriated expenditures were used to deliver the Federal contribution to aviation programs. As the IRS has had over 30 years of experience administering the current system, some argue that it is preferable to keep the current tax structure and adjust the tax rates if additional revenue is needed rather than switch to a user fee system.

Some assert that the tax burden should be more aligned with the costs that different types of users impose on the air traffic system. Commercial aviation carriers have asserted that, under

present law, they pay a disproportionate share of the costs relative to their use of the system. Passenger ticket taxes comprise roughly two-thirds of the aviation taxes collected. It has been asserted that it requires the same air traffic control resources to track a jet filled with paying business passengers, as it does to track the corporate jet flying the corporation's employees to the same location. As a result, some may argue that the taxes (or fees) imposed on such flights should be the same to reflect the costs to the air traffic system. However, under present law, the commercial flight is subject to the ticket tax, while in the case of the corporate jet, as general aviation, only the fuel tax applies. For example, according to FAA Administrator Marion Blakey "a typical commercial airliner flying from LaGuardia to Miami would pay approximately $2,015 in taxes. In contrast, a large private jet, flying the same distance, through the same airspace, using the same air traffic services, would pay roughly $236 in fuel taxes."[405] In this respect, proponents of the proposal argue that present law does not reflect user cost to the system.

On the other hand, some contend that the current air traffic system has been developed primarily to support the airline industry, and that the incremental costs to accommodate general aviation users are not that large. As a result, they contend that the existing tax structure adequately reflects user cost.

Under the proposal, the FAA would be permitted to adjust the 69.6-cents-per-gallon fuels tax and certain other fees based on an analysis of FAA costs. To analyze costs, the FAA has implemented a cost accounting system that attempts to measure the total expense incurred by the FAA in providing various air traffic control and other services to air system users. The FAA proposal generally would attempt to allocate these measures of total expense to the various air system users.

Current tax structure and adequacy of funding

Some argue that because the bulk of the tax revenue under present law is tied to the price of an airline ticket, it is possible that revenues could fluctuate, creating a gap between costs and revenues. The current excise tax structure yielded roughly $11.5 billion in 2007, and that amount is forecasted to increase yearly. Thus, some may argue that the current tax structure is yielding revenues sufficient to cover the expenditures of the Airport and Airway Trust Fund.[406] Others argue that while possible to finance trust fund expenditures and upgrade and modernize

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[405] Marion C. Blakey, Administrator, Federal Aviation Administration, Statement of Marion C. Blakey, Administrator, Federal Aviation Administration, Before the Senate Committee on Finance, On Financing the Next Generation Air Transportation System (July 12, 2007) at 5.

[406] *See*, Government Accountability Office, *Federal Aviation Administration: Viability of Current Funding Structure for Aviation Activities and Observations on Funding Provisions of Reauthorization Proposals* (GAO-07-1104T, July 12, 2007) at 2. GAO also notes that a number of issues could affect the overall cost of the FAA's next generation aviation system and thus, the level of support needed from the trust fund. The Administration's projections of excise tax receipts and user fees under the proposal indicate there will be a net decrease in receipts over present law for the period 2010-2013. Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2009* (2008) at 276 and 277.

the air traffic control system through the current structure, such modernization may not be able to be implemented as quickly when compared to funding predicated on a cost-based system.[407]

Administrative issues

In general, kerosene, like gasoline and diesel fuel, is taxed when the fuel is removed from a refinery or registered pipeline or terminal. Typically, these fuels are transferred by pipeline or barge in large quantities ("bulk") to terminal storage facilities. A fuel is taxed when it "breaks bulk," i.e. when it is removed from the refinery or terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The party liable for payment of the taxes is the "position holder." i.e. the person shown on the terminal facility records as the owner of the fuel.

For example, under present law, when kerosene (including jet fuel) breaks bulk at a terminal facility and is transferred into a tanker truck for delivery to an airport, it is taxed at 24.4 cents per gallon. For purposes of determining the tax rate at the time the fuel breaks bulk and is transferred into a truck or rail car, it is irrelevant under present law whether the fuel is destined for an airport or for use as motor fuel; the 24.4-cents-per-gallon rate applies. The lower rates for aviation use of kerosene are achieved through refunds when the fuel is used in aircraft.

In 2004, Congress moved the taxation of jet fuel to the terminal rack to address concerns of fuel tax evasion when the tax was imposed further downstream. Before Congress made this change, it was possible to remove jet fuel from the terminal rack without payment of tax if it was asserted that the fuel was destined for aviation use. Under prior law, the Code allowed undyed aviation-grade kerosene to be removed from terminals without payment of the Highway Trust Fund tax if (1) the kerosene was removed by pipeline to an airport, or (2) the fuel was removed for aviation use by or on behalf of a registered aviation fuel dealer. The dealer, typically a wholesale distributor, in turn was responsible for payment of any Airport and Airway Trust Fund tax that may be due upon subsequent sale or use of the fuel. Thus, this tax was imposed at a point in the fuel distribution chain subsequent to removal from a terminal facility. As a result, under prior law it was possible to remove kerosene, divert it to highway use, and avoid any payment of tax by fraudulently asserting at the terminal rack that the fuel was destined for use in an aircraft.

Although the 2004 change substantially reduced the opportunity for this type of fuel tax evasion, the change did not fully eliminate the rate differential for undyed kerosene removed (by

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[407] The FAA asserts that the fundamental issue is not with the tax rates, but with the tax structure not being tied to air traffic costs. Federal Aviation Administration, Frequently Asked Questions (visited February 25, 2008) <http://www.faa.gov/regulations_policies/reauthorization/media/Questions_Answers.pdf>. "This system does not have a direct relationship between the taxes paid by users and the air traffic control services provided by the FAA. Under the reauthorization proposal, FAA would collect user fees from commercial aviation operators for air traffic control (ATC) services. Implementing user fees for ATC services creates incentives to make the system more efficient and responsive to user needs. FAA would have the authority to collect the user fees that directly offset the costs of its operations. . ." Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2009* (2008) at 277.

truck or rail car) from the terminal rack to be used in aviation (21.9 cents per gallon) compared to fuel removed for highway use (24.4 cents per gallon). In 2005, Congress eliminated the rate differential, taxing all such kerosene at 24.4 cents per gallon, unless the fuel was removed directly from the terminal into the fuel tank of an aircraft, and permitting claims for refund or payment for the difference between the rate paid (24.4 cents per gallon) and the aviation rate when use as aviation fuel could be proven. By moving the taxation of kerosene to the terminal rack, and taxing all kerosene as the same rate, Congress intended to deter fuel tax evasion that can result when fuel is removed from a terminal at a point when ultimate use of the fuel is unknown.

The proposal would result in two rates for kerosene when removed from a terminal by truck or rail car. Kerosene destined for aviation use would be taxed at 69.7 cents per gallon, while kerosene destined for nonaviation use would be taxed at 24.4 cents per gallon. As noted above, when jet fuel is removed from the terminal rack and transferred into a tanker truck, the ultimate use of that fuel as aviation fuel is not assured. Under the proposal, if one asserts that kerosene will be used for aviation purposes, the tax is almost triple the rate for other kerosene. Some may argue that such a disparity in rates encourages tax evasion through misrepresentation of the intended use of the fuel to obtain the lower nonavaiation rate. Wholesalers purchasing jet fuel at the terminal for removal by truck may claim such fuel is for a nonaviation use in order to benefit from the lower highway rate for kerosene (24.4 cents per gallon) while later diverting the fuel to aviation use and avoiding the 69.7-cent-per gallon tax.

Present law does provide a rate differential for kerosene used in aviation, but only in instances where the fuel is going directly from the terminal into the fuel tank of an aircraft. In that case, use as aviation fuel is assured. However, under the proposal, when jet fuel is removed from a terminal and placed into a tanker truck at 24.4 cents per gallon based on a representation of non-aviation use, and then the fuel is later diverted to aviation use, it is unclear that the IRS will be able to recover the additional 46 cents that would be due under the proposal. As a result, the Airway and Airport Trust Fund will not be credited with the tax due on kerosene used in aviation and such funds will not be available for aviation programs.

Under present law, commercial aviation fuel purchasers are able to credit their fuel tax refunds against their other excise taxes. For example, an airline that purchases fuel at 24.4 cents per gallon for commercial aviation because the fuel is trucked to them from a fuel terminal is due a refund of 17.5 cents per gallon. Under present law, in lieu of making a claim for payment from the IRS for the difference, the airline is permitted to credit the amount due to it against its ticket tax liability. Under the proposal, there will no longer be a ticket tax for domestic flights, therefore a significant number of commercial aviation taxpayers will have to wait for refunds of 56 cents per gallon (the difference between 69.6 cents per gallon charged on removal and the ultimate tax liability of 13.6 cents per gallon). This could cause significant cash flow problems for such taxpayers as they wait for the IRS to process their claims.

Delegation of Congressional authority

Under the proposal, the FAA would be permitted to adjust the 69.6-cent tax based on its cost allocation study every two years. It is not clear whether there would be any limits placed on the amount of any tax increase FAA could impose. Some would argue that it is the prerogative

of the Congress to set tax rates and that such authority should not be delegated to an administrative agency.

Prior Action

A similar proposal was included in the President's fiscal year 2008 budget proposal.[408]

[408] The House of Representatives passed H.R. 2881 on September 20, 2007. That bill included provisions to increase the taxes for aviation fuel used on noncommercial aviation to 35.9 cents per gallon. The tax on aviation gasoline would be increased to 24.1 cents per gallon. The Senate Commerce Committee reported S.1300, which would impose a $25 surcharge on turbojet and turboprop aircraft to finance NextGen system improvements. On November 13, 2007, the Senate Finance Committee reported S. 2345, which would extend the current taxes on commercial aviation, increase the tax on international arrivals and departures, and increase the aviation fuel tax to 35.9 cents per gallon for noncommercial aviation use of jet fuel. The bill also creates a $58 per flight tax for fractional ownership aircraft. The full Senate has not taken up the House bill, nor acted on its own Airport and Airway Trust Fund reauthorization bill. Several short-term extensions of the current taxes have been enacted, the most recent extension terminating on June 30, 2008.

K. Modify Financing of the Inland Waterways Trust Fund

Present Law

A permanent 20-cents-per-gallon excise tax is imposed on fuel used in powering commercial cargo vessels while traveling on a designated system of 27 inland and intracoastal waterways.[409] The waterways include the Mississippi River upstream from Baton Rouge, the Mississippi River's tributaries, the Gulf of Mexico and Atlantic Intracoastal Waterways and the Tennessee-Tombigbee Waterway.

The excise tax does not apply to fuel for vessels primarily used for passenger transportation. Nor does it apply to fuel used in deep-draft oceangoing vessels. Additional exemptions are provided for fuels used by State and local governments in transporting property in governmental business and for fuels used by tugs moving LASH (lighter-aboard-ships) and SEABEE oceangoing barges released by their oceangoing carriers solely to pick up or deliver international cargoes.

The inland waterways excise tax, and related trust fund, were enacted as part of 1978 legislation. The tax rate initially was four cents per gallon, with scheduled increases to 10 cents per gallon. In 1986, additional phased increases were enacted to reach the current 20-cents-per-gallon rate. The trust fund also earns investment interest.

The Army Corp of Engineers is responsible for the construction, operation and maintenance of inland waterway infrastructure. Present law allows up to fifty percent of the cost of construction projects to be funded by the Inland Waterway Trust Fund.

Description of Proposal

The proposal would replace the fuel tax with a user fee imposed on commercial barges using locks operated by the United States Army Corps of Engineers. The fee would be phased in beginning October 1, 2008, with increases each year through December 31, 2012. Automatic adjustments to the fee would be made annually beginning in 2013, based on the total net assets in the Trust Fund.

As the fee is phased in, the fuel tax would be phased out. The tax rate would be reduced to 10 cents per gallon beginning October 1, 2008, and to 5 cents per gallon beginning October 1, 2009. The tax would be repealed for periods after September 30, 2010.

Analysis

The nation's waterway infrastructure is aging and there will be an increasing need to replace it. This will require additional funds. The President's budget proposal seeks to raise these additional funds through the imposition of a user fee in lieu of the present inland waterway tax.

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[409] Sec. 4042.

Proponents of the proposal argue that the excise tax does not raise enough revenue to pay for the construction and rehabilitation of the locks and dams on the inland and intracoastal waterways. In fiscal year 2007, $91 million was collected from the inland waterway fuel tax. As noted above, it was envisioned that the Inland Waterway Trust Fund would provide 50 percent of the funding for such projects. In the past, the Inland Waterway Trust Fund had a surplus, however, it is projected that the trust fund will run out of money by the end of fiscal year 2009.[410] At the end of FY07, the trust fund had a balance of $137,260,000. The balance at the end of fiscal year 2008, is projected to be $15,724,000. It is believed that the trust fund will be exhausted by the end of fiscal year 2009.

Some argue that the excise tax rate could be increased to provide the necessary funding. However, it has been argued that the excise tax is an inefficient method for raising the necessary funds and that user fees should be imposed on the basis of the costs of the projects. Pricing the fee based on costs could encourage shippers to choose the most efficient means of transportation rather than the cheapest. In addition, a fee based on the cost to improve a lock that is imposed on the user of such lock could be viewed as more equitable than a tax imposed on all users regardless of whether they will use the facilities. The beneficiaries of the construction project would be paying for its cost. Some argue that a fee structure allows for more flexibility than a tax, allowing the fees to be increased when needed to meet construction needs and reduced when that level of spending is no longer needed. Adjusting the tax would require action by Congress. A user fee also could reduce congestion on the waterways as some look for alternate means of transportation to avoid the fee.

On the other hand, in areas dependent on waterway commerce, an increased fee or tax increase specific to a construction project in that area could negatively affect commerce in that area. In some cases, basing the fee on costs could result in dramatic increases as the costs of certain projects may far exceed others. The budget proposal permits the fee to be phased in over time, perhaps to make the impact of increased costs to the user more gradual.

It is not clear from the proposal whether the fees will be set according to each project or set based on an aggregate level of spending to be incurred for that fiscal year. If the same rate applies regardless of the facility being used, the arguments that a fee is more efficient and equitable than a tax are not as strong.

Prior Action

No prior action.

[410] Source, U.S. Army Corp of Engineers.

VI. IMPROVE UNEMPLOYMENT INSURANCE

A. Strengthen the Financial Integrity of Unemployment Insurance

Present Law

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

State Unemployment Insurance taxes are deposited into the State's Federal Unemployment Insurance Trust Fund and are used by the State to pay 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.

Under present law, all States operate experience rating systems. Under these systems an employer's State unemployment tax rate is based on the amount of unemployment benefits paid to the employer's former employees. Generally, the more unemployment benefits paid to former employees, the higher the State unemployment tax rates.

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.

Description of Proposal

The proposal increases incentives for the recovery of State unemployment benefit overpayments, and delinquent employer taxes. The proposal allows States to redirect up to five percent of overpayment recoveries to additional enforcement activity. The proposal requires States to impose a 15 percent penalty on recipients of fraudulent overpayments; the penalty would be used exclusively for additional enforcement activity.

Under the proposal, States are 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 overpayments or delinquent employer taxes, States are permitted to employ private collection agencies to retain a portion (up to 25 percent) of such overpayments or delinquent taxes collected. In addition, the proposal provides that the Secretary of the Treasury, upon request of a State, will reduce any income tax refund owed to a benefit recipient when that recipient owes a benefit overpayment to the requesting State.

The proposal requires employers to report the starting date of employment for all new hires to the NDNH. Finally, the proposal authorizes the Secretary of Labor to waive certain requirements to allow States to conduct Demonstration Projects geared to reemployment of individuals eligible for unemployment benefits.

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

Analysis

States' abilities to reduce unemployment benefit overpayments and increase overpayment recoveries are limited by funding. In addition, the present-law requirement that States redeposit recoveries of overpayments to the Federal Unemployment Insurance Trust Fund creates a relative disincentive for States to increase enforcement activity. Permitting States to redirect five percent of overpayment recoveries to additional enforcement activity provides States with additional resources to detect and recover overpayments. The proposal also deters noncompliance by imposing a 15 percent penalty on fraudulent overpayments and provides States additional resources by requiring penalty proceeds to be used exclusively for enforcement activity. However, the proposal does not provide a definition of what will be considered fraudulent. The lack of a uniform definition of a fraudulent overpayment may result in disparate treatment of individuals in different States. In addition, there is a question as to whether the Federal government can ensure that amounts redirected from the Federal Unemployment Insurance Trust Fund are used exclusively for State enforcement purposes.

The proposal also prohibits States from relieving employers of benefit charges due to a benefit overpayment if the employer caused the overpayment. Proponents argue this will decrease overpayments resulting from employer error. In addition, the proposal ensures that employers with high error rates bear the burden of additional costs associated with such errors. On the other hand, the proposal does not provide a definition of what will be considered employer fault. Without providing the States criteria for making this determination, there are issues regarding the administrability of such a standard.

The proposal permitting States to employ private collection agencies to retain a portion of certain fraudulent overpayments or delinquent employer taxes collected may permit States to more efficiently allocate resources to enforcement activities. The proposal does not, however, describe the circumstances when private collection agencies will be allowed to retain a portion of taxes collected and some question whether it is appropriate to compensate such agencies based on the success in collecting taxes that are due.

There are administrability issues regarding the proposal requiring the Secretary to reduce any income tax refund owed to an unemployment benefit recipient when that recipient owes an overpayment to a State requesting offset. Present law provides States a limited right of offset

with respect to legally enforceable State income tax obligations. Present law also establishes the priority of State income tax obligations relative to other liabilities. The proposal neither defines how the IRS will determine whether unemployment overpayments are legally owed to a State nor describes the relative priority of such offsets. Clarification of these issues is necessary to implement this element of the proposal. Finally, some question whether it is appropriate to provide States an offset right in non-income tax cases, thus, expanding the circumstances in which the Federal government acts a collection agent for the States.

Proponents argue that the proposal requiring employers to report the starting date of employment for all new hires to the NDNH will reduce unemployment benefit overpayments. Obtaining taxpayer data from a centralized source such as the NDNH, rather than from separate State agencies, should increase the efficiency of enforcement efforts. However, others respond that allowing States to access the NDNH for administering unemployment benefits extends the use of the database beyond that which was originally intended to enable state child support enforcement agencies to be more effective in locating noncustodial parents.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, and 2008 budget proposals.

B. Extension of Federal Unemployment Surtax

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through 2008.

Description of Proposal

The proposal extends the temporary surtax rate through December 31, 2009.

Effective date.−The proposal is effective for labor performed on or after January 1, 2009.

Analysis

The proposal reflects the belief that a surtax extension is needed in order to increase funds for the Federal Unemployment Trust Fund to provide a cushion against future Trust Fund expenditures. The monies retained in the Federal Unemployment Account of the Federal Unemployment Trust Fund can then be used to make loans to the 53 State Unemployment Compensation benefit accounts as needed.

An argument against the proposal is that an extension is not necessary at this time because Federal Unemployment Trust Fund projected revenues are sufficient to cover projected expenditures for the next several years. Some argue that the proposal is simply an attempt to improve the unified Federal budget by collecting the surtax for an additional year.

Prior Action

A similar proposal was included in the President's fiscal year 2007 and 2008 budget proposals.

VII. ENERGY PROVISIONS

A. Repeal Temporary 15-Year Recovery Period for Natural Gas Distribution Lines

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." Except where provided specifically by statute, the class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[411] In the Revenue Procedure, natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years. However, natural gas distribution pipelines the original use of which commences with the taxpayer after April 11, 2005, and which are placed in service before January 1, 2011, are assigned a statutory 15-year recovery period.[412]

Description of Proposal

Under the proposal, the temporary 15-year recovery period for natural gas distribution lines is repealed for property placed in service after December 31, 2008. Thus, under the proposal, all natural gas distribution lines placed in service after December 31, 2008 are assigned a recovery period of 20 years and a class life of 35 years.

Effective date.–The proposal is effective for property placed in service after December 31, 2008.

Analysis

The temporary reduced recovery period for natural gas distribution lines under present law encourages investment in such property by reducing the present-value after-tax cost of investment. In considering the adoption of a shorter recovery period, the Senate Committee on Finance and the House Ways and Means Committee each cited an aging energy infrastructure and a desire to encourage investment in energy property:

> The Committee recognizes the importance of modernizing our aging energy infrastructure to meet the demands of the twenty-first century, and the Committee also recognizes that both short-term and long-term solutions are required to meet this challenge. The Committee understands that investment in our energy infrastructure has not kept pace with the nation's needs. In light of this, the Committee believes it is appropriate to reduce the recovery period for investment

[411] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[412] Sec. 168(e)(3)(E)(viii).

in certain energy infrastructure property to encourage investment in such property.[413]

However, supporters of the proposal to repeal the reduced recovery period argue that the nation's energy policy should be focused not just on modernization but on increased energy supply, and that incentives for investment should therefore be offered to suppliers rather than distributors. This argument suggests that the reduced recovery period should be repealed in favor of incentives for energy production and energy efficiency.

Proponents also argue that the shorter recovery period unfairly benefits gas utilities over competitors such as electric utilities.[414] This argument raises two primary questions. The first question is whether it is accurate that the 15-year and 20-year recovery periods for gas utilities and electric utilities, respectively, favor investment in gas distribution lines over electric distribution lines. The second question is, if so, whether there is a policy justification for doing so.

The first question is one of neutrality, and requires analysis of the economic lives of the properties whose recovery periods are being compared. Conforming the recovery period of a property as closely as possible to the economic life of the property results in a more accurate measure of economic income derived from such property. Additionally, to the extent that the depreciation schedules of other property are designed to accurately measure economic depreciation, a depreciation schedule for an asset class that deviates from economic depreciation may distort investment decisions. If the depreciation schedule provides for faster cost recovery than economic depreciation, an incentive is created to invest in such assets relative to other assets. Similarly, if the depreciation schedule provides for slower cost recovery than economic depreciation, a disincentive to invest in such assets is created. If the depreciation schedules uniformly match economic depreciation, the depreciation system will be generally neutral as to the choice of investment across asset classes. Such neutrality promotes economically efficient investment choices by helping to insure that investments with the highest post-tax return (the return that the investor cares about) are also those with the highest pre-tax return (the measure of the value of the investment to society). Thus, the 15-year recovery period for gas distribution lines creates an advantage for gas distributors over electric utilities only if it is shorter than the economic life of the gas distribution lines to a greater degree than the 20-year recovery period for electric utility lines is shorter than their economic life.

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[413] *See* H.R. Rep. No. 108-67, at 51 (2003) and S. Rep. No. 108-54, at 58 (2003). Sec. 168(e)(3)(E)(viii) was enacted as part of the Energy Policy Act of 2005 (Pub. L. No. 109-58). While neither tax committee filed a committee report with respect to the Energy Policy Act of 2005, a substantially identical provision to sec. 168(e)(3)(E)(viii) was passed by both the House and the Senate in 2003. The quoted text appears in each of the cited committee reports under the heading "Reasons for Change."

[414] While high voltage electric transmission lines are also assigned a 15-year recovery period, the lower voltage lines which go into individual homes are recovered over 20 years. No such distinction exists with respect to the depreciable life of gas lines; thus, gas lines which serve individual homes and businesses are eligible for the 15-year recovery period under present law.

The relationship between the economic lives of gas distribution lines and electric utility lines is unclear and would require an empirical study to determine. As part of the Tax and Trade Relief Extension Act of 1998,[415] Congress directed the Secretary of the Treasury to conduct a study of recovery periods and depreciation methods, in part due to concerns that present-law depreciation rules may create competitive disadvantages such as the one which could be asserted with respect to gas and electric utilities.[416] In the resulting report, Treasury cited time, cost, and difficulty as reasons not to address the recovery periods of specific assets as part of a study of the overall depreciation system:

> Resolution of the issue of how well the current recovery periods and methods reflect useful lives and economic depreciation rates would involve detailed empirical studies and years of analysis. In addition, the data required for this analysis would be costly and difficult to obtain.[417]

While the time, cost, and difficulty of empirically studying the economic lives of all assets makes doing so impractical, addressing individual assets such as those used in the electric and gas utility industries would be feasible.[418]

The question of whether a policy justification exists for providing an incentive to invest in gas distribution lines rather than electric utility lines is primarily one of efficiency. On one hand, it could be argued that such an incentive is inappropriate policy because it reduces the efficiency of the market, making it less likely to steer consumption decisions toward the least expensive energy sources. However, it could also be argued that an incentive to invest in gas distribution lines overcomes an existing market inefficiency. While certain household appliances and systems can be operated using gas or electric energy, many others require only electricity (e.g., a microwave oven). Thus, electric utilities are likely to be offered to every residential consumer while not all of those consumers are also offered the option of natural gas. An incentive to invest in gas distribution lines may result in more customers having the option to choose between gas and electric energy, allowing them to efficiently choose household appliances according to cost and performance. This would also promote increased competition among energy sources, forcing producers and distributors to become more efficient.

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[415] Division J of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, H.R. 4328, Pub. L. No. 105-206 (1999).

[416] The Congress also cited improper measurement of income and inefficient allocation of investment capital as concerns. See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (JCS-6-98), November 24, 1998, at 279.

[417] Department of the Treasury, *Report to The Congress on Depreciation Recovery Methods and Periods*, July 2000, at 1.

[418] During the years 1989 through 1991, the now-defunct Depreciation Analysis Division of Treasury's Office of Tax Analysis completed a number of property-specific reports which included the results of such studies. A summary of these reports can be found in the Treasury report. See id. at 123.

Prior Action

A similar proposal was included in the President's fiscal year 2007 and 2008 budget proposals.

B. Modify Amortization for Certain Geological and Geophysical Expenditures

Present Law

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. G&G costs incurred by independent producers and smaller integrated oil companies in connection with oil and gas exploration in the United States may generally be amortized over two years.[419]

Major integrated oil companies are required to amortize all domestic G&G costs over seven years for costs paid or incurred after December 19, 2007, the date of enactment of the Energy Independence and Security Act of 2007 (EISA).[420] A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company that has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest of 15 percent or more in a crude oil refiner.

In the case of abandoned property, allocable G&G costs may not be recovered in the year of abandonment of a property as all G&G costs are recovered over the applicable amortization period.

Description of Proposal

The proposal increases the amortization period from two years to seven years for G&G costs incurred by independent producers and smaller integrated oil companies. The seven-year amortization period applies even if the property to which the G&G costs relate is abandoned, and any remaining unamortized G&G costs associated with the abandoned property are recovered over the remainder of the seven-year period.

Effective date.–The proposal is effective for G&G costs paid or incurred in taxable years beginning after December 31, 2008.

Analysis

Prior to the enactment of the Energy Policy Act of 2005, G&G costs were treated as capital expenditures deductible over the useful life of the property to which they related. In the

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[419] This amortization rule applies to G&G costs incurred in taxable years beginning after August 8, 2005, the date of enactment of the Energy Policy Act of 2005, Pub. L. No. 109-58. Prior to the effective date, G&G costs associated with productive properties were generally deductible over the life of such properties, and G&G costs associated with abandoned properties were generally deductible in the year of abandonment.

[420] Pub. L. No. 110-140.

event the G&G costs associated with a particular area of interest did not result in the acquisition or retention of property, the entire amount of the G&G costs allocable to the area of interest was deductible as a loss under section 165 for the taxable year in which such area of interest was abandoned as a potential source of mineral production.

The Energy Policy Act of 2005 established a two-year amortization period for all domestic G&G costs, regardless of whether such costs resulted in the acquisition or abandonment of any property. While this simplified the process for recovering G&G costs, it also had the result of extending the recovery period for G&G costs associated with abandoned property. On average, however, the two-year amortization period accelerated the recovery of G&G costs. Having a more rapid recovery period was intended to foster increased exploration for sources of oil and natural gas within the United States.

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) increased from two years to five years the amortization period for G&G costs incurred by major integrated oil companies. EISA increased from five years to seven years the amortization period for G&G costs incurred by major integrated oil companies. Requiring all oil companies to recover G&G costs over the same period reduces the tax advantage that independent oil companies and smaller integrated oil companies currently have over major integrated oil companies with respect to G&G costs. However, extending from two to seven years the recovery period for domestic G&G costs incurred by independent and smaller integrated oil companies increases the after-tax costs associated with oil and gas exploration in the United States for affected companies and thus reduces the incentive for those companies to engage in such activities. Proponents of the proposal believe that high energy prices are already providing sufficient incentives for the affected companies to invest in oil and gas exploration.

With respect to a seven-year amortization rule more generally, while such a recovery period may more closely match the useful life of property acquired for oil and gas production as a result of the geological and geophysical expenditures, the longer amortization period also increases the difference between the assumed life of the asset for tax purposes versus its actual economic life, in cases where property is abandoned.

Prior Action

A similar proposal imposing a five-year recovery period for domestic G&G costs was included in the President's fiscal year 2007 budget proposal. A similar proposal imposing a five-year recovery period for domestic G&G costs incurred by independent producers and smaller integrated oil companies was included in the President's fiscal year 2008 budget proposal.

VIII. EXTEND EXPIRING PROVISIONS

A. Extend Alternative Minimum Tax Relief for Individuals

Present Law

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The present exemption amount is: (1) $66,250 ($45,000 in taxable years beginning after 2007) in the case of married individuals filing a joint return and surviving spouses; (2) $44,350 ($33,750 in taxable years beginning after 2007) in the case of other unmarried individuals; (3) $33,125 ($22,500 in taxable years beginning after 2007) in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit[421], the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2008, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2007, the nonrefundable personal credits (other than the adoption credit, child credit and saver's credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and saver's credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.[422]

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[421] The child credit may be refundable in whole or in part to a taxpayer.

[422] The rule applicable to the adoption credit and child credit is subject to the EGTRRA sunset.

Description of Proposal

The proposal provides that the individual AMT exemption amount for taxable years beginning in 2008 is $70,050, in the case of married individuals filing a joint return and surviving spouses; (2) $46,250 in the case of other unmarried individuals; and (3) $35,025 in the case of married individuals filing separate returns.

For taxable years beginning in 2008, the bill allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective date.–The proposal is effective for taxable years beginning in 2008.

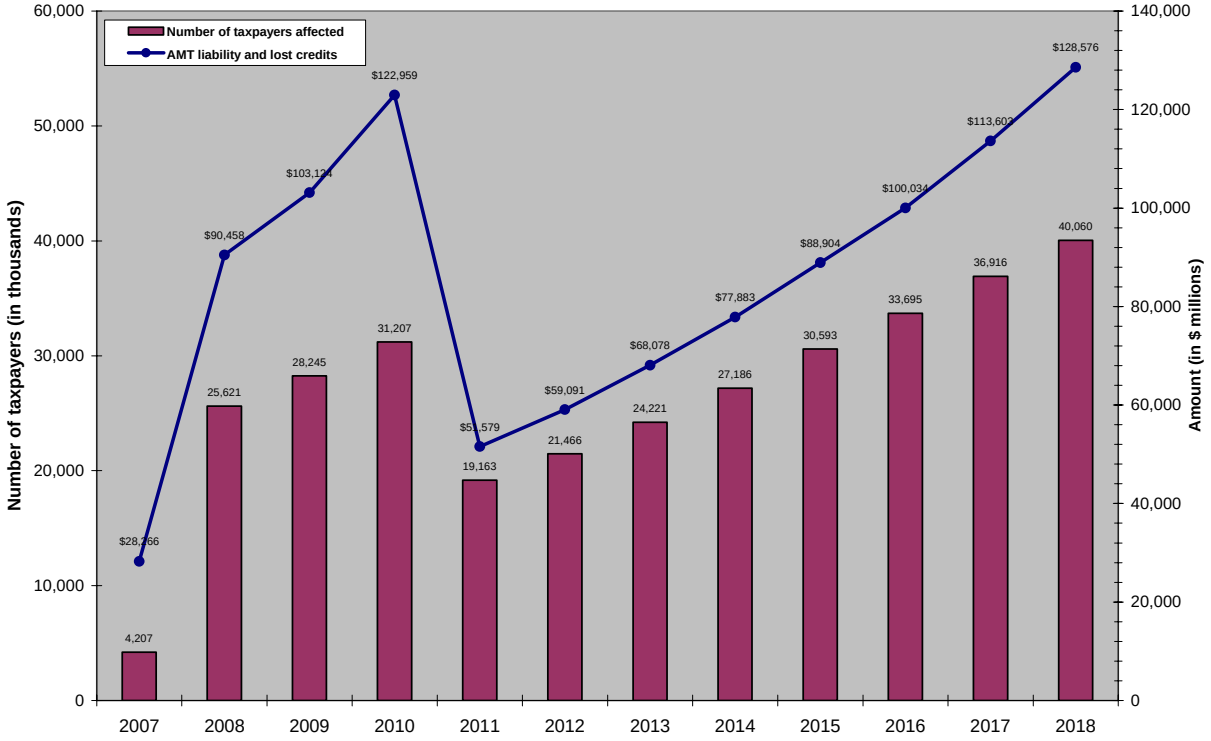
Analysis

Allowing the nonrefundable personal credits to offset the regular tax and alternative minimum tax, and increasing the exemption amounts, will substantially reduce the number of taxpayers affected by the AMT. In addition to the reduction in tax liability as a result of this change, there will be significant simplification benefits. Substantially fewer taxpayers will need to complete the alternative minimum tax form (Form 6251), and the forms and worksheets relating to the various credits can be simplified.

The proposal offers no reason for the specific levels of the exemption chosen other than to "avoid a significant increase in the number of taxpayers subject to the AMT in the near term." The staff of the Joint Committee on Taxation projects that 4.2 million taxpayers would be affected by the AMT in 2008 under the proposal, an amount equal to the estimated 4.2 million taxpayers affected by the AMT under current law in 2007. Figure 1, below, shows the projected number of taxpayers affected by the AMT, and the amount of AMT liability and tax credits lost as a result of the AMT, for years 2007 - 2018.

The increase in the exemption amount from 2007 levels is $3,800 for married taxpayers filing a joint return and $1,900 for unmarried individuals. By choosing an increase that is significantly more than inflation and which for married taxpayers is twice that for unmarried taxpayers, the proposal appears patterned after changes made to the exemption levels in recent years that have attempted to hold the number of taxpayers affected by the AMT constant.

Figure 1.-Taxpayers affected by the AMT Projections: 2007- 2018



If the intent is to hold the number of taxpayers affected by the AMT constant, it should be noted that this approach fails to recognize the varying impacts that the AMT has across filing statuses.[423] Specifically, married taxpayers, especially those with children, are far more likely to be affected by the AMT than unmarried taxpayers. Thus, even though the increase in the exemption level for married taxpayers under the proposal is twice that for unmarried taxpayers, it could be the case that a significantly greater number of married taxpayers would be affected by the AMT under the proposal despite the overall number of taxpayers affected by the AMT being held constant. If this were true, then fewer unmarried taxpayers would be affected by the AMT under the proposal than are affected currently for tax year 2007. Only by independently setting the increase in exemption levels by filing status (as opposed to following a rule that sets the increase for married taxpayers to twice that of unmarried taxpayers) could the proposal hold the number of taxpayers affected by the AMT constant in the aggregate and by filing status.

Finally, to the extent that the purpose of the proposal is to hold the number of taxpayer affected by the AMT constant, changing the exemption levels is neither the only way nor necessarily the least expensive way to effect this result. For example, to the extent that it is the denial of personal exemptions that is the principal reason for taxpayers to be newly affected by

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[423] *See* Joint Committee on Taxation, *Present Law and Background Relating to the Individual Alternative Minimum Tax* (JCX-10-07), March 5, 2007, for a complete discussion of this and other issues related to the AMT.

the AMT, one could consider allowing some or all personal exemptions for purposes of the AMT rather than increasing exemption levels. Or, combinations of policies could be chosen, such as making smaller increases in exemption levels coupled with partial or full allowance of exemptions.

The following example compares the effect of not extending minimum tax relief with the effect of the proposal extending minimum tax relief:

Example.–Assume in 2008, a married couple has an adjusted gross income of $80,000, they do not itemize deductions, and they have four dependent children, two of whom are eligible for the child tax credit and two of whom are eligible for a combined $3,000 HOPE Scholarship credit. The couple's net tax liability (under present law and the proposal) is shown in Table 5 below.

Table 5.–Comparison of Individual Tax Liability Under Present Law and Proposal, 2008

	Present Law	Proposal
Adjusted gross income	$80,000	$80,000
Less standard deduction[424]	10,900	10,900
Less personal exemptions (6 @ $3,500)	21,000	21,000
Taxable income	48,100	48,100
Regular tax	6,413	6,413
Tentative minimum tax	9,100	2,587
HOPE Scholarship credit before tax limitation	3,000	3,000
HOPE credit after tax limitation	0	3,000
Child tax credit	2,000	2,000
Net tax (greater of (i) tentative minimum tax less child credit or (ii) regular tax less allowable credits)	7,100	1,413
Net tax reduction due to extension of provisions		5,687

Prior Action

Similar proposals were included in the President's fiscal year 2004, 2005, 2007, and 2008 budget proposals.

The exemption amounts have been increased and the credit allowance provision extended, most recently, for taxable years beginning in 2007, by the Tax Increase Prevention Act of 2007.

[424] This example assumes the taxpayers do not elect to itemize their deductions.

B. Permanently Extend the Research and Experimentation ("R&E") Tax Credit

Present Law

General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[425] Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.[426]

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the university basic research credit and the energy research credit, expired and generally will not apply to amounts paid or incurred after December 31, 2007.[427]

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[425] Sec. 41.

[426] Sec. 41(e).

[427] The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years. The research tax credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate university basic research credit.

The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") extended the research tax credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's

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also modified the method for calculating a taxpayer's base amount (i.e., by substituting the present-law method, which uses a fixed-base percentage, for the prior-law moving base which was calculated by reference to the taxpayer's average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1990 extended the research tax credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

The Tax Extension Act of 1991 extended the research tax credit for six months (i.e., for qualified expenses incurred through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the research tax credit for three years--i.e., retroactively from July 1, 1992 through June 30, 1995. The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience.

Although the research tax credit expired during the period July 1, 1995, through June 30, 1996, the Small Business Job Protection Act of 1996 ("1996 Act") extended the credit for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime). In addition, the 1996 Act expanded the definition of start-up firms under section 41(c)(3)(B)(i), enacted a special rule for certain research consortia payments under section 41(b)(3)(C), and provided that taxpayers may elect an alternative research credit regime (under which the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage otherwise applicable and the credit rate likewise is reduced) for the taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997.

The Taxpayer Relief Act of 1997 ("1997 Act") extended the research credit for 13 months--i.e., generally for the period June 1, 1997, through June 30, 1998. The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury). The Tax and Trade Relief Extension Act of 1998 extended the research credit for 12 months, i.e., through June 30, 1999.

The Ticket to Work and Work Incentive Improvement Act of 1999 extended the research credit for five years, through June 30, 2004, increased the rates of credit under the alternative incremental research credit regime, and expanded the definition of research to include research undertaken in Puerto Rico and possessions of the United States.

The Working Families Tax Relief Act of 2004 extended the research credit through December 31, 2005. The Energy Policy Act of 2005 added the energy research credit. The Tax Relief and Health Care Act of 2006 extended the research credit through December 31, 2007, modified the alternative incremental research credit, and added an election to claim an alternative simplified credit.

qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[428]

In computing the credit, a taxpayer's base amount can not be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[429] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[430]

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[431] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

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[428] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

[429] Sec. 41(f)(1).

[430] Sec. 41(f)(3).

[431] Sec. 41(c)(4).

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above are increased to three percent, four percent, and five percent, respectively.[432]

An election to be subject to this alternative incremental credit regime can be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Alternative simplified credit

Generally, for amounts paid or incurred after 2006, taxpayers may elect to claim an alternative simplified credit for qualified research expenses.[433] The alternative simplified research credit is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes January 1, 2007. The transition rule applies only to the taxable year which includes that date.

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the

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[432] A special transition rule applies for fiscal year 2006-2007 taxpayers.

[433] A special transition rule applies for fiscal year 2006-2007 taxpayers.

taxpayer's behalf (so-called contract research expenses).[434] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research does not only have to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[435] In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.[436] Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[437] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[438] Taxpayers

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[434] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

[435] Sec. 41(d)(3).

[436] Sec. 41(d)(4).

[437] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

[438] Sec. 280C(c).

may alternatively elect to claim a reduced research tax credit amount (13 percent) under section 41 in lieu of reducing deductions otherwise allowed.[439]

Description of Proposal

The research tax credit is made permanent.

Effective date.–The proposal is effective for amounts paid or incurred after December 31, 2007.

Analysis

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm are cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency.[440] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. However, there is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[441] Nevertheless, even if there were agreement that additional subsidies for research are warranted as a general matter, misallocation of research dollars across competing sectors of

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[439] Sec. 280C(c)(3).

[440] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

[441] *See* Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. XCIV, (1992), M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993, and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43. Charles I. Jones and John C. Williams, "Measuring the Social Return to R&D," *Quarterly Journal of Economics*, 113, November 1998, also conclude that "advanced economics like the United States substantially under invest in R&D" (p. 1120).

the economy could diminish economic efficiency. It is difficult to determine whether, at the present levels and allocation of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency.

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal Government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little consensus regarding magnitude of the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should increase research activities beyond what they otherwise would be. However, the present law research credit contains certain complexities and compliance costs.

Scope of research activities in the United States and abroad

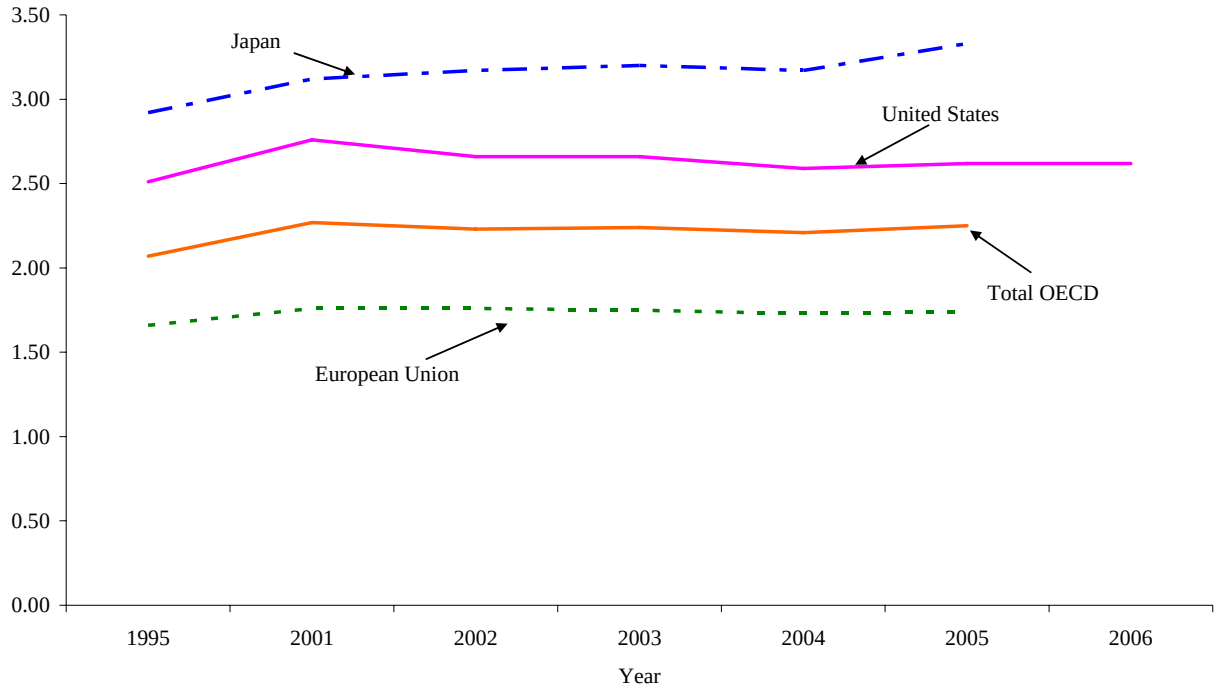
In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.6 percent of gross domestic product in 2005 and 2006.[442] This rate of expenditure on research and development exceeds that of the European Union and the average of all countries that are members of the Organisation for Economic Co-operation and Development ("OECD"), but is less than that of Japan. See Figure 2, below. In 2005, expenditures on research and development in the United States represented 42.2 percent of all expenditures on research and development undertaken by OECD countries, were 40 percent greater than the total expenditures on research and development undertaken in the European Union, and were more than two and one half times such expenditures in Japan.[443] Expenditures on research and development in the United States have grown at an average real rate of 3.69 percent over the period 1995-2005. This rate of growth has exceeded that of France (1.52 percent), the United Kingdom (1.86 percent), Japan (2.46 percent), Italy (2.50 percent), and

[442] Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Scoreboard, 2007*, (Paris: Organisation for Economic Co-operation and Development), 2007. This data represents outlays by private persons and by governments. The figures reported in this paragraph and Figure 2 do not include the value of tax expenditures, if any. The OECD calculates that the United States spent approximately $344 billion on research and development in 2006. Organisation for Economic Co-operation and Development, *Main Science and Technology Indicators, 2007*, vol. 2, (Paris: Organisation for Economic Co-operation and Development), 2007.

[443] OECD, *Science, Technology and Industry Scoreboard, 2007*. While the OECD attempts to present these data on a standardized basis the cross-country comparisons are not perfect. For example, the United States reporting for research spending generally does not include capital expenditure outlays devoted to research while the reporting of some other countries does include capital expenditures.

Germany (2.57 percent), but is less than that of Canada (4.95 percent), Spain (7.34 percent), and Ireland (7.40 percent).[444]

Figure 2.−Gross Domestic Expenditure on R&D as a Percentage of GDP, United States, Japan, the European Union, and the OECD, 1995-2005



Source: OECD, Main Science and Technology Indicators, 2007, vols. 1 & 2.

Direct expenditures are not the only means by which governments subsidize research activities. A number of countries, in addition to the United States, provide tax benefits to taxpayers who undertake research activities. The OECD has attempted to quantify the relative value of such tax benefits in different countries by creating an index that measures the total value of tax benefits accorded research activities relative to simply permitting the expensing of all qualifying research expenditures. Table 6, below, reports the value of this index for selected countries. A value of zero would result if the only tax benefit a country offered to research activities was the expensing of all qualifying research expenditures. Negative values reflect tax benefits less generous than expensing. Positive values reflect tax benefits more generous than expensing. For example, in 2006 in the United States qualifying taxpayers could expense

[444] OECD, *Main Science and Technology Indicators, 2007*, vol. 2. The annual real rate of growth of expenditures on research and development for the period 1995-2005 in the European Union and in all OECD countries at 2.94 percent and 3.61 percent, respectively. All reported growth rates are calculated in terms of U.S. dollars equivalents converted at purchasing power parity.

research expenditures and, in certain circumstances claim the research and experimentation tax credit. The resulting index number for the United States is 0.07.[445]

Table 6.−Index Number of Tax Benefits for Research Activities in Selected Countries, 2006

Country	Index Number[1]
Italy	-0.02
Germany	-0.03
Ireland	0.05
United States	0.07
United Kingdom	0.10
France	0.19
Japan	0.12
Canada	0.17
Spain	0.44

[1] Index number reported is only that for "large firms." Some countries have additional tax benefits for research activities of "small" firms.

Source: OECD, *OECD Science, Technology and Industry Outlook, 2006*.

Scope of tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit was estimated to be $5.0 billion for 2007. The related tax expenditure for expensing of research and development expenditures was estimated to be $1.3 billion for 2007 growing to $6.2 billion for 2011.[446] As noted above, the Federal Government also directly subsidizes research activities.

[445] Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Outlook, 2006*. (Paris: Organisation for Economic Co-operation and Development), 2006. The index is calculated as one minus the so-called "B-index." The B-index is equal to the after-tax cost of an expenditure of one dollar on qualifying research, divided by one minus the taxpayer marginal tax rate. Alternatively, the B-index represents the present value of pre-tax income that is necessary to earn in order to finance the research activity and earn a positive after-tax profit. In practice, construction of the B-index and the index number reported in Table 6 requires a number of simplifying assumptions. As a consequence, the relative position of the tax benefits of various countries reported in the table is only suggestive.

[446] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07), September 24, 2007, p. 24.

Direct government outlays for research have substantially exceeded the annual estimated value of the tax expenditure provided by either the research and experimentation tax credit or the expensing of research and development expenditures. For example, in fiscal 2007, the National Science Foundation for research and related activities was $4.7 billion, the Department of Defense's budget for research, development, test and evaluation was $75.9 billion, the Department of Energy's science budget was $3.8 billion, and the Department of Health and Human Services' budget for the National Institutes of health was $28.9 billion.[447] However, such direct government outlays generally are for directed research on projects selected by the government. The research credit provides a subsidy to any qualified project of an eligible taxpayer with no application to a grant-making agency required. Projects are chosen based on the taxpayer's assessment of future profit potential.

Tables 7 and 8 present data for 2005 on those corporations that claimed the research tax credit by industry and asset size, respectively. Over 17,000 corporations (counting both C corporations and S corporations) claimed more than $6.6 billion of research tax credits in 2005.[448] Corporations whose primary activity is manufacturing account for just more than one-half of all corporations claiming a research tax credit. These manufacturers claimed more than 70 percent of all credits. Firms with assets of $50 million or more account for about 15 percent of all corporations claiming a credit but represent more than 86 percent of the credits claimed. Nevertheless, as Table 8 documents, a large number of small firms are engaged in research and were able to claim the research tax credit. C corporations claimed almost $6.4 billion of these credits and, furthermore, nearly all of this $6.4 billion was the result of the firm's own research. Only $136 million in research credits flowed through to C corporations from ownership interests in partnerships and other pass-through entities.

For comparison, individuals claimed $273 million in research tax credits on their individual income tax returns in 2005. This $273 million includes credits that flowed through to the individual from pass-through entities such as partnerships and S corporations as well those credits generated by sole proprietorships.

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[447] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2009*, pp. 127, 49, 62, and 67.

[448] The $6.6 billion figure reported for 2005 in not directly comparable with the Joint Committee on Taxation Staff's $4.8 billion tax expenditure estimate for 2005 (Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005, p. 30) reported in the preceding paragraph. The tax expenditure estimate accounts for the present-law requirement that deductions for research expenditures be reduced by research credits claimed. Also, the $6.6 billion figure does not reflect the actual tax reduction achieved by taxpayers claiming research credits in 2005 as the actual tax reduction will depend upon whether the taxpayer had operating losses, was subject to the alternative minimum tax, or other aspects specific to each taxpayer's situation.

Table 7.–Percentage Distribution of Corporations Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2005

Industry	Percent of Corporations Claiming Credit	Percent of Total R & E Credit
Manufacturing	50.7	71.2
Professional, Scientific, and Technical Services	25.3	10.2
Information	6.7	9.8
Wholesale Trade	6.2	3.1
Finance and Insurance	1.5	1.9
Holding Companies	2.4	1.5
Retail Trade	0.9	0.7
Health Care and Social Services	1.0	0.4
Utilities	0.2	0.3
Transportation and Warehousing	0.9	0.2
Administrative and Support and Waste Management and Remediation Services	2.4	0.2
Agriculture, Forestry, Fishing, and Hunting	1.0	0.2
Mining	0.1	(1)
Real Estate and Rental and Leasing	0.1	(1)
Construction	0.2	(1)
Other Services	0.2	(1)
Arts, Entertainment, and Recreation	(2)	(2)
Educational Services	(2)	(2)
Accommodation and Food Services	(2)	(2)
Not Allocable	(2)	(2)
Wholesale and Retail Trade not Allocable	(2)	(2)

[1] Less than 0.1 percent.
[2] Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Table 8.–Percentage Distribution of Corporations Claiming Research Tax Credit and of Credit Claimed by Corporation Size, 2005

Asset Size ($)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	1.4	0.7
1 to 99,999	10.1	0.1
100,000 to 249,999	5.2	0.1
250,000 to 499,999	3.8	0.2
500,000 to 999,999	8.1	0.4
1,000,000 to 9,999,999	37.5	5.4
10,000,000 to 49,999,999	18.7	6.4
50,000,000 +	15.3	86.6

Note: Totals may not add to 100 percent due to rounding.
Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Flat or incremental tax credits?

For a tax credit to be effective in increasing a taxpayer's research expenditures it is not necessary to provide that credit for all the taxpayer's research expenditures (i.e., a flat credit). By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives where they will have the most effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of $105 and Project B will generate cash flow with a present value of $95. Suppose that the research cost of investing in each of these projects is $100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Consider now the situation where a 10-percent flat credit applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to $90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to $90, this previously neglected project (with a present value of $95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits attempt not to reward projects that would have been undertaken in any event but to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures. In the example above, if an incremental credit were properly targeted, the Government could spend the same $20 in credit dollars and

induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded $80. Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's base amount. Tax credits are provided only for amounts above this base amount.

Since a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures considered below their base amount receive no credit.

Fixed base versus moving base credit

With the addition of the alternative simplified credit, taxpayers effectively have the choice of three different research credit structures for general research expenditures.[449] Each of the credit structures is an "incremental" credit. However, the base is determined differently in each case. The regular credit and the alternative incremental credit are examples of "fixed base" credits. With a fixed base credit, the incremental amount of qualified research expenditures is determined without reference to the qualified research expenditures of a prior year. The new alternative simplified credit is a "moving base" credit. With a moving base credit, the incremental amount of qualified research expenditures for a given year is determined by reference to one or more prior year's qualified research expenditures. The distinction can be important because, in general, an incremental tax credit with a base amount equal to a moving average of previous years' qualified expenditures is considered an effective rate of credit substantially below its statutory rate. On the other hand, an incremental tax credit with a base amount determined as a fixed base generally is considered to have an effective rate of credit equal to its statutory rate.

[449] A taxpayer election into one of these structures is permanent unless revoked by the Secretary. However, historically, permission to revoke an election has routinely been granted by the Secretary, effectively making the choice an annual election.

To see how a moving base creates a reduction in the effective rate of credit, consider the structure of the alternative simplified credit. The base of the credit is equal to 50 percent of the previous three years' average of qualified research expenditures. Assume a taxpayer has been claiming the alternative simplified credit and is considering increasing his qualified research expenditures this year. A $1 increase in qualified expenditures in the current year will earn the taxpayer 12 cents in credit in the current year but it will also increase the taxpayer's base amount by 16.7 cents (50 percent of $1 divided by three) in each of the next three years. If the taxpayer returns to his previous level of research funding over the subsequent three years, the taxpayer will receive 2 cents less in credit than he otherwise would have. Assuming a nominal discount rate of 10 percent, the present value of the one year of credit increased by 12 cents followed by three years of credits reduced by 2 cents is equal to 7.03 cents. That is, the effective credit rate on a $1 dollar increase in qualified expenditures is 7 percent.

Some have also observed that a moving base credit can create incentives for taxpayers to "cycle" or bunch their qualified research expenditures. For example, assume a taxpayer who is claiming the alternative simplified credit has had qualified research expenditures of $100 per year for the past three years and is planning on maintaining qualified research expenditures at $100 per year for the next three years. The taxpayer's base would be $50 for each of the next three years and the taxpayer could claim $6 of credit per year. If, however, the taxpayer could bunch expenditures so that the taxpayer incurred only $50 of qualified research next year, followed by $150 in the second year and $100 in the third, the taxpayer could claim no credit next year but $13 in the second year and $6 dollars in the third. While the example demonstrates a benefit to cycling, as the majority of qualified research expenditures consist of salaries to scientists, engineers, and other skilled labor, the potential for cycling most likely would be limited in practice.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of price elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[450] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat

[450] For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity--such as research scientists and engineers--is in short supply.

research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[451]

Despite the central role of the measurement of the price elasticity of research activities, the empirical evidence on this subject has yielded quantitative measures of the response of research spending to tax incentives. While all published studies report that the research credit induced increases in research spending, early evidence generally indicated that the price elasticity for research is substantially less than one. For example, one early survey of the literature reached the following conclusion:

> In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of -0.2 and -0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[452]

If it took time for taxpayers to learn about the credit and what sort of expenditures qualified, taxpayers may have only gradually adjusted their behavior. Such a learning curve might explain a modest measured behavioral effect.

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[451] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise--so called marginal research expenditures--need be subject to the credit to have a positive incentive effect.

[452] Charles River Associates, An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive (final report prepared for the National Science Foundation), February, 1985, p. G-14. The negative coefficient in the text reflects that a decrease in price results in an increase in research expenditures. Often, such elasticities are reported without the negative coefficient, it being understood that there is an inverse relationship between changes in the "price" of research and changes in research expenditures.

In a 1983 study, the Treasury Department used an elasticity of 0.92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. See, Department of the Treasury, "The Impact of Section 861-8 Regulation on Research and Development," p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerable smaller. For example, the General Accounting Office (now called the Government Accountability Office) summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." See, *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3." See, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191.

A more recent survey of the literature on the effect of the tax credit suggests a stronger behavioral response, although most analysts agree that there is substantial uncertainty in these estimates.

> [W]ork using US firm-level data all reaches the same conclusion: the tax price elasticity of total R&D spending during the 1980s is on the order of unity, maybe higher. … Thus there is little doubt about the story that the firm-level publicly reported R&D data tell: the R&D tax credit produces roughly a dollar-for-dollar increase in reported R&D spending on the margin.[453]

However this survey notes that most of this evidence is not drawn directly from tax data. For example, effective marginal tax credit rates are inferred from publicly reported financial data and may not reflect limitations imposed by operating losses or the alternative minimum tax. The study notes that because most studies rely on "reported research expenditures" that a "relabelling problem" may exist whereby a preferential tax treatment for an activity gives firms an incentive to classify expenditures as qualifying expenditures. If this occurs, reported expenditures increase

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[453] Bronwyn Hall and John Van Reenen, "How effective are fiscal incentives for R&D? A review of the evidence," *Research Policy*, vol.29, 2000, p. 462. This survey reports that more recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to fully appreciate the incentive structure of the revised credit. See, Bronwyn H. Hall, "R&D Tax Policy During the 1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 7, (Cambridge: The MIT Press, 1993), pp. 1-35. Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, including an additional 76 firms, that had initially been excluded because they had been involved in merger activity, the estimated elasticities fell by half. See, James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s" in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, (Chicago: University of Chicago Press 1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, "R&D Tax Incentives and Manufacturing-Sector R&D Expenditures," in James M. Poterba, editor, *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment*, (Washington, D.C.: National Academy Press), 1997. While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, "Does Government R&D Policy Mainly Benefit Scientists and Engineers?" *American Economic Review*, vol. 88, May, 1998, pp. 298-302.

in response to the tax incentive by more than the underlying real economic activity. Thus, reported estimates may overestimate the true response of research spending to the tax credit.[454]

Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

Other policy issues related to the research and experimentation credit

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below base, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the alternative minimum tax ("AMT") or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[455]

Except for energy research, firms with research expenditures substantially in excess of their base amount are subject to the 50-percent base amount limitation. In general, although these firms received the largest amount of credit when measured as a percentage of their total qualified research expenses, their marginal effective rate of credit was exactly one half of the statutory credit rate of 20 percent (i.e., firms subject to the base limitation effectively are governed by a 10-percent credit rate).

Although the statutory rate of the research credit was 20 percent, it is likely that the average marginal effective rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms were subject to various limitations discussed above yield

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[454] Hall and Van Reenen, "How effective are fiscal incentives for R&D? A review of the evidence," p. 463.

[455] As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, i.e., between 12 and 15 percent.[456]

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will drift from the firm's actual current qualified research expenditures. Therefore, if the research credit were made permanent, increasingly over time there would be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms would receive no credit and have no reasonable prospect of ever receiving a credit, while other firms would receive large credits (despite the 50-percent base amount limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average marginal effective rate of credit would decline while the revenue cost to the Federal Government increased.

As explained above, because costly scientific and technological advances made by one firm may often be cheaply copied by its competitors, research is one of the areas where there is a consensus among economists that government intervention in the marketplace, such as the subsidy of the research tax credit, can improve overall economic efficiency. This rationale suggests that the problem of a socially inadequate amount of search is not more likely in some industries than in other industries, but rather it is an economy-wide problem. The basic economic rationale argues that a subsidy to reduce the cost of search should be equally applied across all sectors. As described above, the Energy Policy Act of 2005 provided that energy related research receive a greater tax subsidy than other research. Some argue that it makes the tax subsidy to research inefficient by biasing the choice of research projects. They argue that a energy related research project could be funded by the taxpayer in lieu of some other project that would offer a higher rate of return absent the more favorable tax credit for the energy related project. Proponents of the differential treatment for energy related research argue that broader policy concerns such as promoting energy independence justify creating a bias in favor of energy related research.

Complexity and the research tax credit

Administrative and compliance burdens also resulted from the research tax credit. The General Accounting Office ("GAO") has testified that the research tax credit had been difficult for the IRS to administer. The GAO reported that the IRS states that it is required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes. While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more

[456] For a more complete discussion of this point, see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 65-66.

detailed than those necessary to support the deduction of research expenses under section 174.[457] An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

> Tax incentives such as the R&D tax credit … typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. … [I]s what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.[458]

In addition to compliance challenges, with the addition of the alternative simplified credit, taxpayers now have three research credit structures to choose from, not including the energy research credit and the university basic research credit. The presence of multiple research credit options creates increased complexity by requiring taxpayers to make multiple calculations to determine which credit structure will result in the most favorable tax treatment.

Prior Action

The President's budget proposals for fiscal years 2003 through 2006 contained an identical proposal. The President's budget proposal for fiscal year 2007 contained a similar proposal, but did not extend or make permanent the energy research credit. The President's budget proposal for fiscal year 2008 contained an identical proposal.

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[457] Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate, April 3, 1995.

[458] David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, vol. 50, September 1997, pp. 487-493.

C. Extend District of Columbia Homebuyer Tax Credit

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expired for residences purchased after December 31, 2007.[459]

Description of Proposal

The proposal extends the first-time homebuyer credit for two years, through December 31, 2009.

Effective date.–The proposal is effective for residences purchased after December 31, 2007.

Analysis

The D.C. first-time homebuyer credit is intended to encourage home ownership in the District of Columbia in order to stabilize or increase its population and thus to improve its tax base.

A number of policy issues are raised with respect to whether the D.C. homebuyer credit should be extended. One issue is whether it is the proper role of the Federal government to distort local housing markets by favoring the choice of home ownership in one jurisdiction over another. Favoring home ownership in one area comes at the expense of home ownership in adjacent areas. Thus, if the credit stimulates demand in the District of Columbia, this comes at the expense of demand in other portions of the relevant housing market, principally the nearby suburbs of Virginia and Maryland.

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[459] Sec. 1400C(i). The District of Columbia first-time homebuyer credit was enacted as part of the Taxpayer Relief Act of 1997 and was scheduled to expire on December 31, 2000. The Tax Relief Extension Act of 1999 extended the first-time homebuyer credit for one year, through December 31, 2000. The Community Renewal Tax Relief Act of 2000 extended the first-time homebuyer credit for two additional years, through December 31, 2003. The Working Families Tax Relief Act of 2004 extended the first-time homebuyer credit for two additional years, through December 31, 2005. The Tax Relief and Health Care Act of 2006 extended the first-time homebuyer credit for two additional years, through December 31, 2007.

To the extent that local jurisdictions vary in their tax rates and services, individuals purchasing a home may choose to buy in the jurisdiction that offers them the combination of tax rates and services and other amenities that they desire.[460] If a jurisdiction has a low tax rate, some might choose it on that basis. If a jurisdiction has a high tax rate but offers a high level of services, some will decide that the high tax rate is worth the services and will choose to buy in that jurisdiction. If tax rates are high but services are not correspondingly high, individuals may avoid such jurisdictions. It is in part this individual freedom to choose where to live that can promote competition in the provision of local public services, helping to assure that such services are provided at reasonable tax rates. If a jurisdiction fails at providing reasonable services at reasonable tax rates, individuals might choose to move to other jurisdictions. This may cause property values in the jurisdiction to fall and, together with taxpayer departures, may put pressure on the local government to change its behavior and improve its services. If the Federal government were to intervene in this market by encouraging the purchase of a home in one local market over another, competition among local jurisdictions in the provision of public services may be undermined.

In the above scenario, however, a dwindling tax base may make it financially difficult to improve government services. Some argue that the District of Columbia is in this position and that it needs Federal assistance to improve the District's revenue base. An alternative view is that the tax credit could take some of the pressure off the local government to make necessary improvements. By improving the local government's tax base without a commensurate improvement in government services, the Federal expenditure could encourage a slower transition to better governance.

Some argue that the credit is appropriate because a number of factors distinguish the District of Columbia from other cities or jurisdictions and that competition among the District and neighboring jurisdictions is constrained by outside factors. For example, some argue that the credit is a means of compensating the District for an artificially restricted tax base. While many residents of the suburbs work in the District and benefit from certain of its services, the Federal government precludes the imposition of a "commuter tax," which is used by some other jurisdictions to tax income earned within the jurisdiction by workers who reside elsewhere. In addition, some argue that the District has artificially reduced property, sales, and income tax revenues because the Federal government is headquartered in the District. The Federal government makes a payment to the District to compensate for the forgone revenues, but some argue that the payment is insufficient. Some also argue that to the extent migration from the District is a result of poor services, it is not entirely within the control of the District to fix such problems, because the District government is not autonomous, but is subject to the control of Congress.

Another issue regarding the D.C. homebuyer credit is how effectively it achieves its objective. Several factors might diminish its effectiveness. First, the $5,000 will not reduce the net cost of homes by $5,000. Some of the $5,000 is likely to be captured by sellers, as eligible

[460] Other factors may also affect the choice of where to live, such as closeness to work or family members.

buyers entering the market with effectively an additional $5,000 to spend will push prices to levels higher than would otherwise attain. If the supply of homes for sale is relatively fixed, and potential buyers relatively plentiful, then the credit will largely evaporate into sellers' hands through higher prices for homes.

A second reason the credit might not be very effective at boosting the residential base of the District is that it applies to existing homes as well as any new homes that are built. Thus, the family that sells its D.C. home to a credit-eligible buyer must move elsewhere. To the extent that they sell in order to move outside of the District of Columbia, there is no gain in D.C. residences. And, to the extent that the credit caused home prices to rise, the credit can be seen as an encouragement to sell a home in the District as much as an encouragement to buy.

Finally, the income restrictions on the credit might lead to a lower level of average incomes in the District of Columbia than would have otherwise been the case in the absence of the credit. Such lower average incomes would reduce the D.C. income tax base, thus potentially undermining an objective of the credit, if the lower average income is not outweighed by an increase in the number of residents. To see how this could be so, consider two families, each seeking housing in the D.C. area, one with an income of $100,000 who is eligible for the full credit and one with an income of $130,000 and thus not eligible. Now consider two homes, one in Virginia and one in the District of Columbia, that each can objectively be said to be worth $500,000 in the absence of the credit. The credit eligible family with the lower income has a much greater incentive to buy the D.C. home, as the net cost to them would be only $495,000, assuming the price did not increase as a result of the credit. The credit ineligible family would be indifferent. Because of the credit, credit eligible families would be willing to pay up to $505,000 for the home in the District, at which point they would be indifferent between the D.C. home and the $500,000 Virginia home. Because of demand induced by the credit, the price of the D.C. home might thus increase to, perhaps, $502,000, yielding a net cost to the credit eligible buyer of $497,000. To the credit eligible buyers, the $502,000 price for the D.C. home has a lower net cost than the $500,000 Virginia home, and thus they would prefer the D.C. home at the higher gross price. The credit ineligible buyers would not partake in bidding up the price of the D.C. home because they would bear the full cost of the higher sales price, and would thus prefer the similar Virginia home at the $500,000 price to any price above $500,000 for the D.C. home. The outcome might be that some upper middle class families get "pushed out" to the suburbs as a result of the credit, which would actually undermine the District's income tax base because average incomes would fall as a result.

Prior Action

A similar proposal was included in the President's fiscal year 2004, 2005, 2006, 2007, and 2008 budget proposals.

D. Deferral of Gains From the Sale of Electric Transmission Property

Present Law

Generally, a taxpayer recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision. With regard to the disposition of certain electric transmission property, taxpayers may elect to recognize gain from qualified electric transmission transactions ratably over an eight-year period if the amount realized from such sale is used to purchase exempt utility property within four years after the close of the taxable year in which the transaction takes place.[461] If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain shall be recognized to the extent of such excess in the year of the qualifying electric transmission transaction, with any remaining realized gain recognized ratably over the eight-year period.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2008. In general, an independent transmission company is defined as: (1) an independent transmission provider[462] approved by the Federal Energy Regulatory Commission ("FERC"); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than December 31, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

If the taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

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[461] Sec. 451(i).

[462] For example, a regional transmission organization, an independent system operator, or an independent transmission company.

Description of Proposal

The proposal extends the provision allowing the deferral of tax on the gain from the sale or disposition of electric transmission property one year. Therefore, taxpayers may elect deferral with respect to sales or dispositions that occur before January 1, 2009. Additionally, the deadline for achieving operational control of transmission facilities by a FERC-approved independent transmission provider in cases in which qualification as an independent transmission company depends on such control is extended for one year.

Analysis

While gain realized from the sale or disposition of property is generally included in income currently, the Code provides special rules for certain transactions that permit gain to be recognized in future periods. The special deferral rule contained in this proposal relates to electric deregulation that has been occurring, and is continuing to occur, at both the Federal and State level. Federal and State energy regulators are calling for the "unbundling" of electric transmission assets held by vertically integrated utilities, with the transmission assets ultimately placed under the ownership or control of independent transmission providers (or other similarly-approved operators). This policy is intended to improve transmission management and facilitate the formation of competitive markets.[463]

To facilitate the implementation of these policy objectives, the proponents believe it is appropriate to assist taxpayers in moving forward with industry restructuring by providing a tax deferral for gain associated with certain dispositions of electric transmission assets.[464] In addition, because the proposal requires the proceeds of such dispositions to be reinvested in utility property, the proponents argue that this tax incentive will assist in modernizing our energy infrastructure.[465] However, those opposed to this proposal argue that gain on the sale or disposition of property should be measured and included in the period in which the related transaction takes place. They further argue that providing special rules for certain industries and situations increases the tax system's complexity and indirectly increases the tax burden on other taxpayers.

Proponents of the proposal to extend the provision argue that its intended purpose would be best served by permitting the deferral of gain on qualifying transactions beyond the expiration date of January 1, 2008. It would continue to provide the benefits described above and provide certainty to those considering such transactions that deferral will be permitted. In contrast, an argument against extension is that the expiration date encourages taxpayers to comply with electric restructuring policies in a timely manner.

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[463] *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05), May 2005 at 517.

[464] Id at 518.

[465] *See* H.R. 1531, the "Energy Tax Policy Act of 2003," which was reported by the Committee on Ways and Means on April 9, 2003 (H.R. Rep. No. 108-67).

The proposal would continue to require additional effort and examination resources in auditing taxpayers that have undertaken a transaction eligible for the special treatment under this provision. Furthermore, the extension of this provision would continue the need for additional records and computations to be maintained by taxpayers to properly reflect the consequences of this provision. However, the number of eligible transactions should not be significant and taxpayers likely to benefit from the proposal may have the resources to comply with the additional records and computations necessary.

Prior Action

A proposal to extend the deferral of tax on the gain from the sale or disposition of electric transmission property was included in the President's fiscal year 2008 budget proposal.

E. Extend the New Markets Tax Credit

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[466] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A "low-income community" is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (rather than 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of

[466] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[467] Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006, 2007, and 2008.

Description of Proposal

The proposal extends the new markets tax credit for one year, through 2009, permitting up to $3.5 billion in qualified equity investments for that calendar year.

Effective date.−The provision is effective on the date of enactment.

Analysis

The proposal would authorize an additional year of new markets tax credits. To date, Congress has authorized $16 billion in new market tax credit allocations (including a special $1 billion allocation for Gulf Coast areas affected by Hurricane Katrina). As reported by the Treasury Department, with respect to the first four rounds of new markets tax credit allocations,

[467] 12 U.S.C. 4702(17) (defines "low-income" for purposes of 12 U.S.C. 4702(20)).

organizations were awarded tax credits on $12.1 billion of equity investments and raised $8.84 billion in equity from investors. Through 2006, the allocatees reported making $5.45 billion in loans and investments in low-income communities nationwide.[468] Of the $12.1 billion in allocations awarded, applicants requested approximately $107 billion in allocations, thus the program is significantly oversubscribed.[469] Data of the Community Development Financial Institutions Fund, a joint-administrator of the program with the IRS, show that for fiscal year 2004, 92 percent of loans and investments were made in geographic areas evidencing "higher" distress (e.g., communities with unemployment rates at least 1.5 times the national average, empowerment zones, renewal communities), and that the loans and investments made were at below-market rates and with terms more flexible than those typically provided by typical credit products.[470] Banks and bank holding companies represent 75 to 80 percent of the institutional investors participating in the program.[471]

In January 2007, the General Accountability Office issued a Congressionally mandated study of the new markets tax credit program.[472] The GAO made a number of findings: banks and individuals constitute the majority of new markets tax credit claimants (70 percent through 2006); businesses in low-income communities received investments from CDEs to fund over 580 projects, totaling over $3 billion of investment; the program is oversubscribed (as indicated above); projects funded were chiefly commercial real estate construction and rehabilitation; the investments occurred in communities widely dispersed geographically with about 90 percent in areas designated as high distress because of low median incomes or high unemployment rates; an estimated 64 percent of investors reported increasing their investment budget share for low-income communities because of the credit; satisfying government regulations may be an important incentive in addition to the credit to making low-income community investments; corporate investors generally shifted investments from other uses to take advantage of the credit and did not make new investments.

The GAO concluded that their survey results and statistical analysis is consistent with the new markets tax credit program "increasing investment in eligible low-income communities." The GAO inferred that "the most likely effect of the credit is that corporate investors . . . are shifting investment into low-income communities from higher income communities" and that

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[468] U.S. Treasury Department Office of Public Affairs: 6th Round of New Markets Tax Credit Competition Kicks Off; Credits Available for $3.5 billion in Investments to Help Low-Income Communities (December 18, 2007).

[469] New Markets Tax Credits: Unlocking Investment Potential, Comptroller of the Currency, Administrator of the National Banks, U.S. Department of the Treasury, (February 2007) 15.

[470] *Id.* at 3.

[471] *Id.* at 11.

[472] General Accountability Office, Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance, GAO-07-296 (January 2007).

individual investors as a group "appear to be making at least some new investment". The GAO stated that the presence of such additional investment for low-income communities is an indicator that the new markets tax credit program is effective. However, the GAO said that it was beyond the scope of their analysis to determine whether the presence of new market tax credit investors results in any reduction of low-income community investments by other investors and noted that a determination of program effectiveness should include an assessment of the costs of the program and a measurement of the program's economic and social benefits (e.g., reduction in poverty, higher employment rates, reductions in crime, improved health in a community).

In addition, the GAO concludes that compliance efforts by the IRS can be improved. The GAO says that IRS does not have sufficient information to identify investors and the amount of credit investors are entitled to claim. The GAO notes that as more CDEs file returns with the IRS, the IRS will have better opportunities to select CDEs for audit and use information from CDEs in the IRS's ongoing compliance study.

On balance, the existing studies of the new markets tax credit program indicate that the program is meeting the Congressional objective of directing investments to low-income communities. The program is vastly oversubscribed and, as the GAO concluded, is resulting either in a shift of investment from higher income areas to low-income areas or in new investment in low-income areas. It could be argued that as the IRS gains additional experience with the credit and responds to GAO's concerns about compliance shortfalls, that administrability concerns will be reduced.

Prior Action

No prior action.

F. Subpart F Exception for Active Financing Income

Present Law

Under the subpart F rules,[473] 10-percent-or-greater U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[474]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income").[475]

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[473] Secs. 951-964.

[474] Prop. Treas. Reg. sec. 1.953-1(a).

[475] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be

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Assistance Act of 2002 (Pub. L. No. 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009.

based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Description of Proposal

The proposal extends for one year (for taxable years beginning before 2010) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective date.–The proposal is effective for taxable years of foreign corporations beginning after December 31, 2008, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Analysis

Background of the active financing exception

In a pure worldwide tax system, resident individuals and entities are taxable on their worldwide income, regardless of where the income is derived. Double taxation of foreign income is mitigated through the allowance of a foreign tax credit. However, the credit is generally limited to ensure that the residence country preserves its right to tax income derived within the residence country. Since corporations are generally respected as separate entities, foreign-source income earned by a resident through a foreign corporation generally is not subject to tax until repatriated.

In the United States, several anti-deferral regimes apply as exceptions to this general rule and tax U.S. shareholders currently on certain mobile or passive income derived through certain foreign corporations. One of these anti-deferral regimes is the subpart F rules. When the subpart F rules were first enacted in 1962, Congress expressed concern about the avoidance of U.S. tax by U.S.-controlled foreign corporations. The concern expressed was that "foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends are paid by the foreign corporations to their American parent corporations or to their other American shareholders."[476] The subpart F rules were described by the Senate Finance Committee in 1962 as "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations."[477] The subpart F

[476] Revenue Act of 1962, Report of the Committee on Ways and Means, House of Representatives, to accompany H.R. 10650, H. Rep. No. 1447, 87th Cong., 2d Sess., Mar. 16, 1962, 57; Revenue Act of 1962, Report of the Committee on Finance, United States Senate, to accompany H.R. 10650, S. Rep. No. 1881, 87th Cong., 2d Sess., Aug 16, 1962, 78.

[477] S. Rep. No. 1881, Aug. 16, 1962, supra, 79.

rules, as enacted, did not fully end deferral, as they do not apply to certain types of active business income of U.S. controlled foreign corporations. By requiring current inclusion, the subpart F rules serve to reduce incentives for taxpayers to shift income offshore, whether through transfer pricing or other means, in order to avoid U.S. taxation. The subpart F rules conceptually have functioned to require current inclusion by U.S. controlled foreign corporations of income earned overseas that is passive or easily moveable.

The treatment of financial services income under the subpart F rules has changed over the period since 1962. Until 1986, exceptions to foreign personal holding company income under the subpart F inclusion rules were provided for dividends, interest, and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing, or similar business, or derived from the investments made by an insurance company of its unearned premiums or reserves.[478] In 1986, however, these exceptions were repealed.[479] The temporary active financing exception was added to subpart F in 1997,[480] and substantially revised in 1998.[481]

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[478] Prior-law section 954(c)(3)(B). As a rationale for providing these exceptions from subpart F inclusion, Congress stated in 1962: "The second important modification provides that certain income otherwise defined as foreign personal holding company income is not foreign personal holding company income for purposes of this new provision when it arises in connection with certain actual business activities. . . . It is also provided that dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business will not be considered foreign personal holding company income. Another exception is made for dividends, interest and gains from the sale of stock or securities derived from the investments made by an insurance company of its unearned premiums or reserves necessary for the proper conduct of its insurance business." S. Rep. No 1881, Aug. 16, 1962, supra, 83.

[479] Tax Reform Act of 1986, Pub. L. No. 99-514. At the time the provision was reported in the House of Representatives in 1985, Congress stated as a rationale for repealing subpart F exceptions for income from banking, financing, or similar businesses and income from insurance businesses: "The committee believes that these exceptions often provide excessive opportunities for taxpayers to route income through foreign countries to maximize U.S. tax benefits. The lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere. The proliferation of U.S.-controlled banking and insurance companies in various tax haven jurisdictions suggests that many taxpayers are in fact taking advantage of the ability to earn dividends, interest, and gains through such entities, on which the U.S. tax is deferred and the foreign tax is often insignificant." Tax Reform Act of 1985, Report of the Committee on Ways and Means of the House of Representatives, H. Rep. 99-426, Dec. 7, 1985, 393. A narrower provision was included in the Senate bill (see Tax Reform Act of 1986 as reported by the Senate Committee on Finance, S. Rep. 99-313, May 29, 1986, 364, 368), though the House bill provision was ultimately adopted in conference with several modifications (H. Rep. 99-841, Sept. 18, 1986, II-616).

[480] Taxpayer Relief Act of 1997, Pub. L. No. 105-34. When the active financing exception to the subpart F rules was enacted in 1997, Congress referred to prior law in stating its reasons for making the change: "The subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of income of a CFC that is either passive or easily moveable. Prior to the enactment of the

Tax policy issues

In the Taxpayer Relief Act of 1997, one-year temporary exceptions from the subpart F income inclusion rules were enacted for income from the active conduct of an insurance, banking, financing, or similar business. In 1998, the exceptions were substantially modified and extended. In 1999, 2002 and 2006, the exceptions were again extended, and in some cases, modified. Whether to further extend the exceptions raises the question of the merits of the exceptions as a matter of tax policy.

In particular, the proposal presents the question of whether active business income can be adequately distinguished from passive investment income in the case of banking, financing, securities, or insurance businesses. In addition, the proposal presents the question of whether income of these financial services businesses should be subject to current inclusion under subpart F because it is unusually mobile. This analysis presents unique difficulties in the case of financial services businesses, because their income includes items such as interest and dividends that can be characterized as passive investment income or as easily moveable income when held by investors. In other words, in contrast to manufacturing income, for example, the context in which a financial instrument is held takes on special significance in this area.

Passive income

It can be argued that income from the active conduct of a banking or financing, securities broker or dealer, or insurance business is analogous to the type of income from the active conduct of a manufacturing or other non-financial business that is excepted from current inclusion under subpart F. Theses types of income are similar in that both are from the active conduct of a genuine business activity that has a physical nexus with a particular overseas location, and therefore do not represent passive income that is included under the subpart F rules.

Proponents argue that the benefits of the active financing exception are restricted to active income by industry-specific limitations contained in the Code, as amplified by the extensive legislative history.[482] For a banking or financing business, the exception is restricted to income earned in transactions with unrelated non-U.S. customers, provided the business is

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1986 Act, exceptions from foreign personal holding company income were provided for income derived in the conduct of a banking, financing, or similar business or derived from certain investments made by an insurance company. The Congress was concerned that the 1986 Act's repeal of these exceptions resulted in the extension of the subpart F provisions to income that is neither passive nor easily moveable. The Congress believed that the provision of exceptions from foreign personal holding company income for income from the active conduct of an insurance, banking, financing or similar business is appropriate." Revenue Reconciliation Act of 1997 (As Reported by the Committee on Finance), S. 949, S. Rep. 105-33, June 10, 1997, 89-90.

[481] The Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277.

[482] Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 1999, Conf. Rep. to accompany H.R. 4328, H. Rep. 105-825, Oct. 19, 1998, 1554-1575.

predominantly engaged in and conducts "substantial activity" with respect to the business. For a securities dealer, the exception is restricted to income from transactions entered into in the ordinary course of its business as a securities dealer, provided that the income is attributable to its activities in its home country. For an insurance business, the exception is restricted to income from contracts covering non-U.S. risks derived by a company that (1) is regulated as an insurer in the foreign jurisdiction that is its home country, and (2) derives over 50 percent of premiums from home country risks of unrelated persons. In addition, for an insurance business, an exception is provided for investment income (such as interest and dividends), but this exception is restricted to investment income from reserves or unearned premiums allocable to contracts that satisfy the foregoing restrictions, as well as restrictions prohibiting income from related persons and circumscribing the determination of the amount of the reserve or unearned premium. Because of these restrictions, it is argued that the exception applies to income from the core business activities of these financial services businesses, not passive investment income that should be included in income currently under subpart F.

On the other hand, the effectiveness of the temporary provisions in ensuring that income eligible for the exception does not include passive investment income and is limited to business income could be criticized. Though the rules include several mechanical tests, the availability of the active financing exception depends in part on facts and circumstances. For example, a securities dealer is not subject to the "predominantly engaged" and "substantial activity" requirements applicable under the rules for banking, financing or similar businesses, but rather, is subject to different rules that could be characterized as less restrictive or more dependent on facts and circumstances. In the case of a banking, financing or similar business, the corporation is required to conduct "substantial activity" with respect to the banking, financing, or similar business in which it is predominantly engaged. Legislative history sets out a list of activities as guidance as to what constitutes substantial activity in a banking or financing business.[483] Ultimately, the question of substantial activity in the business is one of facts and circumstances. These facts-and-circumstances analyses may be administratively difficult to enforce.

Similarly, in the case of an insurance business, it could be argued that relying (at least in part) on the applicability of insurance regulations of foreign jurisdictions to determine eligibility for the active financing exception does not ensure that the company's main activity is conducting an insurance business or that its activity in the business is substantial. Thus, the applicability of a foreign regulatory regime may not by itself be a good indicator of whether income of the company is passive. Though the rules limit the amount of an insurance company's yield on reserves and on unearned premiums that is eligible for the active financing exception by imposing restrictions on the calculation of reserves and unearned premiums for this purpose, the amount of such income that is ultimately eligible for the exception may not be closely related to any ultimate liability of the company to pay claims. Thus, the income eligible for the exception arguably is not always closely correlated with a core insurance business of insuring risks and paying claims.

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[483] Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 1999, Conf. Rep. to accompany H.R. 4328, H. Rep. 105-825, Oct. 19, 1998, 1562-1563.

Despite such criticisms, it can be said that any determination of whether income of a financial services business is from the core business, or is passive investment income, must depend on a detailed examination of the corporation's activities. A similar examination is required, for example, in connection with the application of the foreign base company sales income rules of section 954(d) to contract manufacturing. Arguably the requirements of the active financing exception, as applied to particular types of financial intermediaries, are more detailed and prescriptive than those applicable to other classes of income eligible for an exception from subpart F. This view argues that these protections prevent much of the income eligible for the active financing exception from being passive. Concerns about complexity and administrability of the law, along with the fundamental difficulty of distinguishing active financial services income from passive income, prevent the rules from being perfectly efficient at eliminating all passive income from eligibility for the exception.

Mobile income

The active financing exceptions include a number of requirements designed to prevent income that is easily moveable from being eligible for the exception. Proponents of the active financing exception argue that these restrictions function adequately to prevent such income from escaping current inclusion, and that the U.S. tax base is accorded sufficient protection by the rules.

In the case of a banking, financing or similar business, income eligible for the exception is subject to the requirement that substantially all the activities relating to the transactions be conducted by the corporation in its home country, and that the income eligible for the exception be treated as earned under the home country's tax laws. Moreover, income derived from U.S. customers is not eligible for the exception.[484] In the case of cross-border income, an additional requirement is imposed that the corporation conduct "substantial activity" with respect to a banking, financing, or similar business in its home country. In addition, non-tax factors may serve to limit the mobility of income, for example, when foreign banking regulators impose prohibitions on moving income out of the country.

In the case of an insurance business, income eligible for the exception must also be treated as earned under the company's home country's tax laws, and at least 50 percent of the company's aggregate net written premiums is required to be from home country risks. In the case of income from insurance of cross-border risks, a substantial activity requirement applies: the company is required to conduct substantial activity with respect to an insurance business in its home country, and is required to perform in its home country substantially all the activities necessary to give rise to the income from the cross-border risk.

[484] Section 954(h)(3)(A); Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 1999, Conf. Rep. to accompany H.R. 4328, H. Rep. 105-825, Oct. 19, 1998, 1563-1564.

On the other hand, the effectiveness of the limitations in the tax rules can be criticized. For example, a 50-percent requirement for home-country risks arguably permits as much as half of an insurance company's underwriting income to be of a type that is easily moveable.

Some point to a de facto liberalization of the subpart F rules effected by the check-the-box regulations, arguing that it shows that mobility of income has declined in importance as a determinant of whether income should be currently included under subpart F.[485] The check-the-box regulations were promulgated by the Treasury Department, however, not by Congress, and did not represent a statement by Congress about the importance of mobility of income as a criterion for subpart F inclusion.

A recent legislative change to subpart F might be characterized as an indication that Congress may be less concerned about mobility of income as a criterion for current inclusion under the subpart F rules. The recently enacted (though temporary) CFC lookthrough rule[486] was designed to allow U.S. companies to reinvest their active foreign earnings where they are most needed by permitting certain transfers between related CFCs without current inclusion under subpart F.[487] On the other hand, it is not clear that Congress intended the CFC lookthrough rule to serve as a statement about mobility of income as a criterion for subpart F inclusion, particularly as the provision is temporary.

Others argue that the 1962 and 1997 rationale for providing a subpart F exception for otherwise easily moveable income from banking, financing, securities, or insurance businesses -- that the income relates to the conduct of an active business -- is flawed. A connection to an active business, whether or not the business is conducted principally in the corporation's home country, arguably does not make income (such as interest or dividends) less easily moveable. Such income is arguably not unlikely to move outside the U.S. tax base. Rather, a reasoned approach would treat mobile income of any business similarly under the subpart F rules: either except mobile income from any business activity, or require such types of income received by any business activity to be included as subpart F income.

An analogy to the income of manufacturing businesses may illustrate that mobile income is an inherent problem in every business. A manufacturing business may have a physical factory

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[485] Treas. Reg. sec. 301.7701-1 through -3, promulgated Dec. 17, 1996. These regulations allow tax classification as a partnership or as a corporation to be explicitly elective (so long as requirements are met) and provide that a single-member unincorporated entity may be disregarded, i.e., treated as not separate from its owner.

[486] Sec. 954(c) (6), effective for taxable years beginning after 2005 and before 2009, was enacted in the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222). The CFC lookthrough rule was enacted in the same legislation extending the active financing exception in 2005.

[487] Commentators point out that the CFC lookthrough rule effectively cuts back on the rules of current inclusion under subpart F, particularly in the case of payments between CFCs that reduce foreign tax. See David R. Sicular, "The New Look-Through Rule: W(h)ither Subpart F?" *Tax Notes*, April 23, 2007, 349.

that produces tangible products, the sale of which gives rise to sales income at a particular outlet or shop. Mobility of income may not appear to be an issue in such a situation. However, that manufacturing operation may be a highly automated facility, located in a "greenfields" setting, in a jurisdiction that provides tax holidays to such operations. The products manufactured at that facility may be specifically designed for and sold to the U.S. market. Moreover, the manufacturing income that the taxpayer reports may have embedded in it the returns on extremely valuable intangibles; the division in turn between true manufacturing profits and implicit returns on intangibles owned by the U.S. parent has been an extremely difficult issue of tax administration for many decades.[488]

Nevertheless, it may be considered harsh to limit eligibility for a subpart F exclusion solely or principally because the income may be easily moveable, if the income is demonstrably not passive but rather is financial services income from an active business in which the corporation is predominantly engaged, and the business has a significant nexus involving the conduct of substantial business activities in the corporation's home country. Under this view, the active financing exceptions fill a need to provide roughly parallel treatment to both manufacturing businesses and financial services under subpart F, despite the unique definitional difficulties in identifying active business income with a nexus to a foreign locale in the case of financial service businesses.

Temporary or permanent exception

Another issue arising from a proposal to extend the active financing exception to the subpart F rules relates to permanence and predictability. If the active financing exception is considered by Congress to be proper and justified, arguably it should be made a permanent rule, rather than being repeatedly extended as a temporary provision. Permanence would provide both taxpayers and the IRS the benefit of certainty, making the tax law more administrable, making enforcement more straightforward, and permitting taxpayers to plan business activities without the needless uncertainty created by a temporary rule that may or may not be extended in the near future. However, a permanent rule could have the effect of encouraging investment abroad by financial services businesses to a greater degree than a temporary rule.

If the active financing exception is deemed appropriate and made permanent, its revenue effect on a permanent basis can be reflected in the Federal budget. The revenue effect of a permanent rule is by definition not reflected each time the temporary rule is extended for a year or for a few years, so the long-term Federal budget impact of repeated extensions is not apparent at the time of each extension. On the other hand, it can be argued that Congress may want to reassess its budget priorities frequently, and that repeated extensions permit such reassessments.

Prior Action

A similar proposal to extend the provision was included in the President's budget proposals for fiscal year 2003.

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[488] *See, e.g.*, Bausch & Lomb Inc. and Consolidated Subsidiaries v. Commissioner, 933 F.2d 1084 (2d Cir. 1991).

G. Look-Through Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Income Rules

Present Law

In general

In general, the rules of subpart F[489] require United States shareholders holding a direct or indirect 10-percent or greater voting interest of a controlled foreign corporation ("CFC") to currently include a pro rata portion of certain income of the CFC (referred to as "subpart F income"), regardless of whether the income is distributed to the United States shareholders.[490] A CFC is any foreign corporation if more than 50 percent of either the combined voting power or total value of its stock is owned, directly, indirectly, or constructively, by United States shareholders.[491]

Subpart F income includes foreign base company income.[492] One category of foreign base company income is foreign personal holding company income. Foreign personal holding company income generally consists of income considered to be passive or highly mobile, including dividends, interest, rents, and royalties.[493] There are several exceptions to these rules. For example, foreign personal holding company income generally does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized if certain conditions are met, or rents and royalties received from a related corporation for the use of property within the country in which the CFC is organized.[494] Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.[495]

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[489] Secs. 951-964.

[490] Sec. 951.

[491] Sec. 957(a).

[492] Sec. 952.

[493] Sec. 954(c).

[494] Sec. 954(c)(3).

[495] Sec. 952(b).

The "look-through rule"

Under the "look-through rule," dividends, interest (including factoring income which is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties, received by one CFC from a related CFC, are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F nor treated as ECI.[496] For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.[497]

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-through rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

The look-through rule applies to taxable years of foreign corporations beginning after December 31, 2005, and ending before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

Description of Proposal

The proposal extends for one year the application of the look-through rule, to taxable years of foreign corporations beginning before January 1, 2010, and to taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

Effective date.–The proposal is effective for taxable years of foreign corporations beginning after December 31, 2008 (but before January 1, 2010), and for taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

Analysis

The purpose of the look-through rule, as stated in its legislative history, is to allow U.S.-owned multinational companies to redeploy their active foreign earnings overseas with no additional U.S. tax burden. This is intended to make U.S. businesses and U.S. workers more competitive with businesses based in other countries, many of which grant a similar benefit to their companies.[498] Because the look-through rule mimics some aspects of territorial tax regimes by facilitating indefinite deferral of income through continued foreign reinvestment of foreign earnings, some argue that the look-through rule tends to make foreign reinvestment relatively more attractive than repatriation and reinvestment of such earnings in the United States.

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[496] The look-through rule, section 954(c)(6), was enacted by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 103(b)(1) (2006).

[497] Sec. 954(d)(3).

[498] *See* H. Rep. No. 109-304, at 45 (2005).

The look-through rule may also have an effect on the realization and use of foreign tax credits. By facilitating the movement of foreign income among foreign entities without creating subpart F income, the look-through rule under some circumstances (or in conjunction with other techniques) may facilitate the separation of relatively high-taxed and low-taxed foreign-source income, permitting a taxpayer to more effectively isolate and time the distribution of high-taxed income to match the taxpayer's ability to use such foreign tax credits currently under the section 904 limitation rules (while also minimizing the amount of low-taxed income which is repatriated to the United States). Some argue that the "check-the-box" Treasury regulations on entity classification[499] permit the creation of legal entity structures that achieve similar results. If so, the principal effect of the look-through rule may be to make such foreign tax credit planning substantially simpler and less expensive, thus increasing the frequency and magnitude of such planning. While some view the availability of this type of foreign tax credit planning as important in leveling the playing field between the United States and countries with territorial tax regimes, the look-through rule can also be viewed as weakening the principles of the subpart F rules.

Prior Action

S. 1273 would make permanent section 954(c)(6). H.R. 3735 would extend section 954(c)(6) through December 31, 2013.

[499] Treas. Reg. secs. 301.7701-1 to -3.

H. Qualified Retirement Plan Distributions to Individuals Called to Active Duty

Present Law

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies.

Among other exceptions, the 10-percent early withdrawal tax does not apply to a qualified reservist distribution.[500] A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") or a tax-sheltered annuity (a "section 403(b) annuity"), or certain similar arrangements, (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the U.S. Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution.[501] The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to the provision. No deduction is allowed for any contribution made under the provision.

Certain amounts held in a section 401(k) plan or a section 403(b) annuity may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee. A section 401(k) plan or section 403(b) annuity does not violate the distribution restrictions applicable to such arrangements by reason of making a qualified reservist distribution.

The present-law rules relating to qualified reservist distributions apply to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007.

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[500] This exception was added by section 827 of the Pension Protection Act of 2006 ("PPA"), effective for distributions after September 11, 2001. Under the PPA, a claim for refund or credit of any overpayment of tax resulting from application of the exception to a prior year is timely if made before the close of the one-year period beginning on the date of enactment of the PPA (August 17, 2006).

[501] Under PPA, the two-year period for making recontributions of qualified reservist distributions does not end before the date that is two years after the date of enactment of the PPA (August 17, 2006).

Description of Proposal

Under the proposal, the rules relating to qualified reservist distributions apply to individuals ordered or called to active duty after September 11, 2001, and on or before December 31, 2009.

Effective date.–The proposal is effective with respect to individuals ordered or called to active duty on or after December 31, 2007, and on or before December 31, 2009.

Analysis

Members of reserve units who are called to active duty for an extended period of time often face difficult financial issues. The present-law provisions relating to qualified reservist distributions help alleviate potential financial hardship by allowing such reservists to draw on their retirement savings without incurring the 10-percent additional tax.

The reduction in retirement savings as a result of early withdrawals may undermine retirement income security. In the case of qualified reservist distributions, the opportunity to recontribute withdrawn amounts after the completion of active duty service may help reservists to restore their retirement savings.

The rules relating to qualified reservist distributions provide more favorable treatment to reservists called to active duty than to other individuals facing temporary financial difficulties. For example, an individual who receives a hardship distribution because the individual's spouse has lost employment is subject to the 10-percent additional tax. Nevertheless, one could argue that the exception for qualified reservist distributions is as sympathetic as many other exceptions to the 10-percent additional tax. The other exceptions include distributions for first home purchases, distributions on account of a tax levy, distributions for medical expenses, distributions to unemployed individuals for the payment of health insurance premiums, and distributions for higher education expenses.

Prior Action

A similar proposal was included in the President’s fiscal year 2008 budget proposal.

I. Extend Provisions Permitting Disclosure of Tax Return Information Relating to Terrorist Activity

Present Law

In general

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Disclosure provisions relating to emergency circumstances

The IRS is authorized to disclose return information to apprise Federal law enforcement agencies of danger of death or physical injury to an individual or to apprise Federal law enforcement agencies of imminent flight of an individual from Federal prosecution.[502] This authority has been used in connection with the investigation of terrorist activity.[503]

Disclosure provisions relating specifically to terrorist activity

Also among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term "terrorist incident, threat, or activity" is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism.[504]

The term "international terrorism" means activities that involve violent acts or acts dangerous to human life that are a violation of the criminal laws of the United States or of any State, or that would be a criminal violation if committed within the jurisdiction of the United States or of any State; appear to be intended to intimidate or coerce a civilian population, to influence the policy of a government by intimidation or coercion, or to affect the conduct of a government by mass destruction, assassination, or kidnapping; and occur primarily outside the territorial jurisdiction of the United States, or transcend national boundaries in terms of the means by which they are accomplished, the persons they appear intended to intimidate or coerce, or the locale in which their perpetrators operate or seek asylum. The term "domestic terrorism"

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[502] Sec. 6103(i)(3)(B).

[503] *See* Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002 (JCX 29-04)*, April 6, 2004.

[504] Sec. 6103(b)(11). For this purpose, "domestic terrorism" is defined in 18 U.S.C. sec. 2331(5) and "international terrorism" is defined in 18 U.S.C. sec. 2331(1).

means activities that involve acts dangerous to human life that are a violation of the criminal laws of the United States or of any State; appear to be intended to intimidate or coerce a civilian population, to influence the policy of a government by intimidation or coercion or to affect the conduct of a government by mass destruction, assassination, or kidnapping; and occur primarily within the territorial jurisdiction of the United States.

In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate Federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2007. The procedures applicable to these provisions are described in detail below.

Disclosure of returns and return information - by ex parte court order

Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies

The Code permits, pursuant to an ex parte court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the ex parte court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that: (1) there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and (2) the return or return information is sought exclusively for the use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

Special rule for ex parte court ordered disclosure initiated by the IRS

If the Secretary of the Treasury (or his delegate) possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary may, on his own initiative, authorize an application for an ex parte court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to

apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS ex parte court order.

Disclosure of return information other than by ex parte court order

Disclosure by the IRS without a request

The Code permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

Disclosure upon written request of a Federal law enforcement agency

The Code permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Code permits the redisclosure by a Federal law enforcement agency to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or the Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of the Department of Justice, Department of the Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and

counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of the Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester.

Description of Proposal

The proposal extends the disclosure authority relating to terrorist activities through December 31, 2009.

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

Analysis

The temporary nature of the present-law provision introduces a degree of uncertainty regarding the disclosure of return information relating to terrorist activities, i.e., whether the provision will be the subject of further extensions. Currently, because the disclosure authority expired on December 31, 2007, no disclosures are being made under these provisions. Table 9 below shows the historical use of the disclosure authority: [505]

[505] The information for this table was taken from Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2006* (JCX-61-07), August 9, 2007; Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2005* (JCX-30-06), June 29, 2006; Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2004* (JCX-63-05), August 19, 2005; Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2003* (JCX-30-04), April 6, 2004; and Joint Committee on Taxation, *Revised Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002* (JCX-29-04) April 6, 2004.

Table 9.–Volume of Disclosures Related to Terrorist Activities (Calendar Years 2002-2006)

Year	IRS Initiated Disclosures 6103(i)(3)(C)(i)	IRS Disclosures to Attorney General to Obtain Ex Parte Court Orders 6103(i)(3)(C)(ii)	Disclosures Under Ex Parte Court Orders 6103(i)(7)(C)	Disclosures in Response to Requests from Intelligence Agencies 6103(i)(7)(B)	Disclosures in Response to Requests from Law Enforcement Agencies 6103(i)(7)(A)
2002	39	25	2,215	0	0
2003	1,626*		1,724	0	0
2004	883*		3,992	0	0
2005	334*		1,366	0	95
2006	48*		908	26	686

*Note: For calendar years 2003, 2004, 2005, and 2006, the IRS did not distinguish between IRS-initiated disclosures and disclosure to the Attorney General to obtain ex parte court orders to disclose tax information.

The data shows a sharp increase in the usage of the disclosure provision by law enforcement for calendar year 2006, from 95 disclosures to 686. After several years of no usage, 26 disclosures were made in response to requests from intelligence agencies. However, IRS-initiated disclosures and disclosures pursuant to ex parte court orders declined from 2005 to 2006. There has been no study of the effectiveness of the disclosure provisions.

Some argue that the terrorist activity disclosure provisions are duplicative of provisions that were already in place for emergency disclosures and for use in criminal investigations. In 2002, the IRS used its emergency disclosure authority to make 12,236 disclosures to the Federal Bureau of Investigation concerning terrorist activity.[506] However, the emergency disclosure

[506] Joint Committee on Taxation, *Revised Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002* (JCX-29-04), April 6, 2004. Similarly, that same year 250 disclosures were made to U.S. Attorneys pursuant to the ex parte court order disclosures provisions generally applicable to criminal investigations.

authorization is to be used under circumstances involving an imminent danger of death or physical injury. In the case of terrorist activity, it may not be clear whether the danger is "imminent," which could lead to the misapplication of the emergency authority and uncertainty as to whether a particular disclosure is authorized. Thus, the existence of a specific disclosure provision for terrorist activity information provides clear authority and direction for making disclosures to combat terrorism.

The requirements for disclosure of terrorist activity information are not as stringent as those required for criminal investigations. For example, the granting of an ex parte order relating to terrorist activities does not require a finding that there is reasonable cause to believe that a specific criminal act has been committed. In cases involving terrorist activity the judge or magistrate needs to determine that there is reasonable cause to believe that the return or return information may be relevant to a matter relating to such terrorist incident, threat or activity. In addition, unlike the requirements for criminal investigations, the judge or magistrate does not need to find that the information cannot be reasonably obtained from another source before granting the request for an ex parte order for disclosure relating to terrorist activity. Some argue that the less stringent requirements facilitate a proactive approach to combating terrorism.

Prior Action

A similar proposal was included in the President's fiscal years 2004, 2005, 2006, 2007, and 2008 budget proposals.

J. Disclosure of Tax Return Information for Administration of Veterans Programs

Present Law

The Code prohibits disclosure of returns and return information, except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure of certain tax information to the Department of Veterans Affairs. Disclosure is permitted to assist the Department of Veterans Affairs in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The Department of Veterans Affairs disclosure provision expires after September 30, 2008.

Description of Proposal

The proposal extends the authority for the IRS to make disclosures to the Department of Veterans Affairs for one year. In addition, the provision would update the cross-references to the non-tax statutes that currently relate to the enumerated Veterans Affairs programs.

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

Analysis

The temporary provision permitting the disclosure of otherwise confidential return information to the Veterans Administration to ensure the correctness of government benefit payments has been in existence since 1990. One could argue that rather than extend the provision temporarily for another year, the provision could be made permanent. The Veterans Administration continues to receive tax information under the provision and permanency would eliminate the uncertainty of extension and potential for disruption associated with a temporary provision.

On the other hand, a temporary extension of present law would allow sufficient time for the Congress and the Administration to determine whether any substantive modifications are needed in terms of the information provided or the purposes for which the information may be used. Some might also argue that the temporary nature of the provision serves as a periodic opportunity for Congress to review the necessity and use of the provision, and to identify any problems that have arisen before reauthorizing it.[507]

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[507] In 1999, the Government Accountability Office has previously reported that safeguard violations had been discovered in connection with the Veteran Affairs use of tax information to

Prior Action

No prior action.[508]

administer certain programs. GAO, *Taxpayer Confidentiality: Federal, State and Local Agencies Receiving Taxpayer Information* (GAO-GGD-99-164, August 1999) at 13. The IRS subsequently reported that the Veterans Administration was addressing this issue satisfactorily. Department of the Treasury, Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volune I: Study of General Provisions (October 2000) at 90.

[508] However, proposals to make the provision permanent were included in versions of H.R. 3997 (110th Cong., 1st Sess.) as passed by the House (the "Heroes Earnings Assistance and Relief Tax Act of 2007"), and as passed by the Senate (the "Defenders of Freedom Tax Relief Act of 2007").

K. Extend Excise Tax on Coal at Current Rates

Present Law

A $1.10 per ton excise tax is imposed on coal sold by the producer from underground mines in the United States. The rate is 55 cents per ton on coal sold by the producer from surface mining operations. In either case, the tax cannot exceed 4.4 percent of the coal producer's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Disability Trust Fund (the "Trust Fund") to finance benefits under the Federal Black Lung Benefits Act. Currently, the Trust Fund is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates are scheduled to decline to 50 cents per ton for underground-mined coal and 25 cents per ton for surface-mined coal (and the cap is scheduled to decline to two percent of the selling price) for sales after January 1, 2014, or after any earlier January 1 on which there is no balance of repayable advances from the Trust Fund to the General Fund and no unpaid interest on such advances.

Description of Proposal

The proposal retains the excise tax on coal at the current rates until the date on which the Trust Fund has repaid, with interest, all amounts borrowed from the General Fund. After repayment of the Trust Fund's debt, the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines will apply and the tax per ton of coal will be capped at two percent of the amount for which it is sold by the producer.

Effective date.–The proposal is effective for coal sales after December 31, 2009.

Analysis

Trust fund financing of benefits was established in 1977 to reduce reliance on the Treasury and to recover costs from the mining industry. Claims were much more numerous than expected and it was difficult to find responsible operators, litigate their challenges, and collect from them. The expenses of the program covered by the Trust Fund (benefits, administration, and interest) have exceeded revenues, with advances from the General Fund making up the difference and accumulating as interest-bearing debt.[509] However, direct costs (benefits and administration) for most years have been less than revenues. According to the Congressional Research Service, if it were not for the interest on the accumulated deficit, the Trust Fund would be self-supporting: "In effect, the annual advances from the Treasury are being used to pay back interest to the Treasury, while the debt has been growing as if with compound interest."[510]

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[509] Congressional Research Service, RS21239 *The Black Lung Benefits Program*, June 12, 2002, at 6.

[510] *Id*.

Interest in effect paid to the Treasury was $717 million in fiscal year 2007 and is estimated at $737 million and $758 million for fiscal years 2008 and 2009, respectively.[511]

The Treasury Department's proposal includes a restructuring of the debt owed by the Trust Fund into a series of zero-coupon bonds payable to the Treasury Department. In order to reimburse the Treasury Department for receiving less interest under the proposal than currently scheduled (due to a general decline in interest rates), a one-time appropriation of $2.288 billion would be made in fiscal year 2009.[512]

Miners and survivors qualify for benefits from the Trust Fund only if the miner's mine employment terminated before 1970 or no mine operator is liable for the payment of benefits. Because the class of beneficiaries is dwindling and revenues currently cover benefits and administrative costs, coal tax revenues could eventually pay off the bonds if the tax were extended at its current rates. However, based on historical trends, it appears that the Trust Fund will not be able to pay off its debt to the Treasury Department by December 31, 2013. Therefore, some argue that it is appropriate to continue the tax on coal at the increased rates beyond that expiration date until the debt is repaid, rather than require that the General Fund provide even larger advances to the Trust Fund. Others assert that the proposal to further extend the rates is premature because the tax is not scheduled to be reduced until December 31, 2013. Still others believe that the interest component of the debt should be forgiven because it is imposed on a loan essentially made by the Federal Government to itself.

Prior Action

Identical proposals (except for effective date) were included in the President's fiscal year 2005, 2006, 2007, and 2008 budget proposals.

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[511] *The Budget for Fiscal Year 2009 (Department of the Treasury)*, at 107.

[512] Congressional Research Service, RS21239 The Black Lung Benefits Program, June 12, 2002, at 6; The Budget for Fiscal Year 2009 (Department of the Treasury), at 107.

L. Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit

Present Law

In general

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone may be excluded from gross income. In addition, 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 the zone.

Child credit

Combat pay that is otherwise excluded from gross income under section 112 is treated as earned income which is taken into account in computing taxable income for purposes of calculating the refundable portion of the child credit.

Earned income credit

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after the date of enactment and before January 1, 2008.

Description of Proposal

The proposal extends the election to treat combat pay as earned income for purposes of the earned income credit for two years (through December 31, 2009).

Effective date.–Generally, the proposal would be effective after December 31, 2007.

Analysis

The exclusion of combat pay from gross income is intended to benefit military personnel serving in combat. However, to the extent that certain tax benefits, such as the child credit and the earned income credit, may vary based on taxable or earned income, the exclusion has the potential to limit the availability of certain refundable tax credits (i.e. the child credit and the earned income credit). Including combat pay in gross income for purposes of the refundable child credit is always advantageous to the taxpayer. However, including combat pay for

purposes of calculating the earned income credit may either help or hurt the taxpayer, because the credit both phases in and phases out based on earned income.[513]

If the objective of the present-law rules is to ensure that the exclusion of combat pay from gross income does not result in a net economic detriment through the elimination of otherwise available refundable credits, an election to include combat pay in income for all Code purposes would be sufficient to achieve that objective. Present law, however, takes a more taxpayer favorable approach by allowing the tax treatment of combat pay to vary across Code provisions when such variation is favorable, and thus present law (1) always treats combat pay as earned income for purposes of the refundable portion of the child credit, as that is always the most favorable result because the refundable child credit can only rise as income rises, and (2) allows the taxpayer to elect to include combat pay as earned income for purposes of the EIC (advantageous to the taxpayer depending on the amount of earned income that would result).

The election to include or exclude combat pay for purposes of the earned income credit creates complexity. In general, elections always add complexity, because taxpayers need to calculate their tax liability in more than one way in order to determine which result is best for them.

The present-law rules with respect to combat pay treat such pay differently than other nontaxable compensation for purposes of the definition of earned income in the refundable child credit and the earned income credit. For example, under present law, other nontaxable employee compensation (e.g., elective deferrals such as salary reduction contributions to 401(k) plans) is not includible in earned income for these purposes. Allowing combat pay to be included in earned income creates an inconsistent treatment between it and other nontaxable employee compensation and arguably creates inequities between taxpayers who receive combat pay compared to other types of nontaxable compensation.

Prior Action

A similar proposal was included in the President's fiscal year 2006, 2007, and 2008 budget proposals.

[513] A similar issue would arise with respect to the child credit, because that credit also is phased out based on adjusted gross income. However, present law addresses this potential adverse effect by including combat pay only for purposes of calculating the refundable portion of the credit.

IX. OTHER PROVISIONS

A. Extension of the Rate of Rum Excise Tax Cover Over to Puerto Rico and Virgin Islands

Present Law

A $13.50 per proof gallon[514] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[515] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[516]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[517] The amount of the cover over is generally limited to $10.50 per proof gallon but a temporary increase of that limitation to $13.25 per proof gallon was in place during the period July 1, 1999 through December 31, 2007.[518]

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[519] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[520] All of the amounts covered over are subject to the limitation.

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[514] A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

[515] Sec. 5001(a)(1).

[516] Secs. 5062(b) and 7653(b) and (c).

[517] Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

[518] Sec. 7652(f)(1). The amount covered over is limited to the amount of excise tax imposed under section 5001(a)(1), if lower than the limits stated above. Sec. 7652(f)(2).

[519] Sec. 7652(e)(2).

[520] Secs. 7652(a)(3), (b)(3), and (e)(1).

Description of Proposal

The proposal extends the temporary $13.25-per-proof-gallon cover over rate for two additional years, through December 31, 2009.

Effective date.–The proposal is effective for articles brought into the United States after December 31, 2007.

Analysis

The fiscal needs of Puerto Rico and the Virgin Islands have been the impetus to extend the increased cover over rate to those possessions. Rather than rely on rum consumption in the United States, increased revenue could be achieved by intergovernmental support through a direct appropriation. The advantage of a direct appropriation is that it provides for annual oversight. Some argue that a cover over is akin to an entitlement in terms of the annual budget process and making it permanent ensures a steady flow of revenue. Although the cover over may provide a more stable revenue stream, it may be more difficult to administer than a direct appropriation.

Prior Action

The temporary $13.25 per-proof-gallon cover over rate had been scheduled to expire after December 31, 2003. The President's fiscal year 2004 and 2005 budget proposals included a proposal that extended the $13.25 per-proof-gallon cover over rate for two additional years, through December 31, 2005. The Working Families Tax Relief Act of 2004 enacted that proposal into law.[521] The President's fiscal year 2007 budget proposal included a proposal that extended the $13.25 per-proof-gallon cover over rate for two additional years, through December 31, 2007. The Tax Relief and Health Care Act of 2006 enacted that proposal into law.[522]

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[521] Pub. L. No. 108-311, sec. 305 (2004).

[522] Pub. L. No. 109-432, sec. 114 (2006).

B. Disclosure of Tax Return Information for Administration of Student Financial Aid

Present Law

Income-contingent loan verification program

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.[523] An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.[524] The Department of Education disclosure authority expired on December 31, 2007.[525]

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.[526] Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather than under the specific exception.[527] The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[528] Thus, because the Department of Education is using a consent-based process, this program is unaffected by the expiration of specific disclosure authority.

Verifying financial aid applications

Student financial aid application is submitted to the Department of Education and is then given to a contractor for processing. Based on the information given, the contractor calculates an expected family contribution that determines the amount of aid a student will receive. All Department of Education financial aid is disbursed directly through schools or various lenders.

The Department of Education requires schools to verify the financial aid information of 30 percent of the applicants. The applicants must furnish a copy of their tax returns. The applicants are not required to obtain copies of tax returns from the IRS or to produce certified

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[523] Sec. 6103.

[524] Sec. 6103(l)(13).

[525] Sec. 6103(l)(13)(D).

[526] Sec. 6103(c).

[527] Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (October 2000) at 91.

[528] Department of Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (February 2003), p. 133.

copies. If the information reflected on the student's copy of the tax return does not match the information on the financial aid application, the school requires corrective action to be taken before a student receives the appropriate aid.

The Office of Inspector General of the Department of Education has reported that, because many applicants are reporting incorrect information on their financial aid applications, erroneous overpayments of Federal Pell grants have resulted.

The Higher Education Act of 1998 ("Higher Education Act") authorized the Department of Education to confirm with the Internal Revenue Service four discrete items of return information for the purposes of verifying of student aid applications.[529] The Higher Education Act, however, did not amend the Code to permit disclosure for this purpose. Therefore, the disclosure provided by the Higher Education Act may not be made unless the taxpayer consents to the disclosure pursuant to section 6103(c). The Deficit Reduction Act of 2005 amended the Higher Education Act again to authorize the Secretary of Education to verify the items listed in section 6103(l)(13) for purposes of student financial aid. However, this amendment also failed to make a corresponding amendment to section 6103 for this purpose and therefore, is inoperative without taxpayer consent.

Overpayments of Pell grants and defaulted student loans

For purposes of locating a taxpayer to collect an overpayment of a Federal Pell grant or to collect payments on a defaulted loan, the Internal Revenue Service may disclose the taxpayer's mailing address to the Department of Education.[530] To assist in locating the defaulting taxpayer, the Department of Education may redisclose the mailing address to the officers, employees and agents of certain lenders, States, nonprofit agencies, and educational institutions whose duties relate to the collection of student loans.[531]

Safeguard procedures and recordkeeping

Federal and State agencies that receive returns and return information are required to maintain a standardized system of permanent records on the use and disclosure of that information.[532] Maintaining such records is a prerequisite to obtaining and continuing to obtain returns and return information. Such agencies must also establish procedures satisfactory to the IRS for safeguarding the information it receives. The IRS must also file annual reports with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint

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[529] Pub. L. No. 105-244, sec. 483 (1998).

[530] Sec. 6103(m)(4).

[531] *Id*.

[532] Sec. 6103(p)(4).

Committee on Taxation regarding procedures and safeguards followed by recipients of return and return information.[533]

Coerced consents

At least one court has held that a coerced consent by a taxpayer to the sharing of return information is invalid.[534] Prompted by allegations of widespread abuse in the Supplemental Security Income ("SSI") program, the Social Security Administration ("SSA") implemented a new policy to verify the income and assets of SSI recipients. Specifically, through a mass mailing distributed in May 1982, the SSA asked each of four million former and current SSI recipients to sign a consent form that would allow the SSA to obtain copies of otherwise confidential tax information maintained by the IRS. This tax information would then be checked against the strict financial limitations that are imposed on SSI recipients, thereby allowing the SSA to eliminate from the program any individuals who are ineligible because their income or assets exceed the maximum allowable levels.[535]

The consent provided:

> You have a choice about signing the form. But we must have accurate information about your income and what you own to pay your Supplemental Security Income checks. If you do not sign the form, your Supplemental Security Income checks may be affected.[536]

Refusal to sign the consent form apparently was grounds for suspending benefits. SSA staff were instructed to inform SSI recipients:

> Since you have not signed the authorization form we cannot determine if you continue to be eligible for Supplemental Security Income payments. Therefore we can not pay you any more benefits beginning month/year.[537]

The court based its decision that the consents were invalid on two independent grounds. First, the consents did not provide the "taxable year" covered by the consent. It purported to give the SSA wholesale access to the recipient's return information. As such it did not comport with the Treasury regulations requiring that the consent address the taxable year covered.[538]

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[533] Sec. 6103(p)(5).

[534] *Tierney v. Schweiker*, 718 F.2d 449, 450 (D.C. Cir. 1983).

[535] *Id.*

[536] *Id.* at 452.

[537] *Id.* at 453.

[538] *Id.* at 455.

The court also found that the consents were coerced.[539] The consents were mailed to four million elderly, blind, and disabled individuals. They contained "poorly-veiled threats that the recipients' benefits would be terminated if they failed to sign the forms."[540] According to the court, that language in the SSA letter was likely to coerce individuals who depend on SSI for their subsistence to give up their right to confidentiality. The court also noted that the SSA failed to explain the substantive and procedural rights of the SSI recipients. Thus, the combination of threats and lack of an explanation of rights prevented the SSI recipients from knowingly and voluntarily consenting to the release of their return information.[541]

Description of Proposal

The Administration plans to verify income information of students and parents with the IRS using a consent-based process.

Analysis

The proposal permits the disclosure of a taxpayer's return information with taxpayer consent. The safeguards and protections afforded by section 6103 do not apply to disclosures made by taxpayer consent. Thus, such information potentially could be disclosed to anyone, not just to Department of Education employees, without restriction or remedy for unauthorized disclosure as provided by the Code. The volume of taxpayer information involved under this proposal and the disclosure of millions of taxpayer records, significantly contributes to the risk of the information being misused for a purpose other than verifying financial aid. On the other hand, some might argue that it is appropriate to permit the disclosure of otherwise confidential tax information to ensure the correctness of Federal student aid. Nonetheless, because present law does not impose restrictions on redisclosure of return information obtained by consent, a proposal, which imposes such restrictions, as well as safeguards to protect the confidentiality of the information disclosed, would be preferable.

Congress has expressed a concern about the increasing number of requests for the disclosure of confidential tax information for nontax purposes and the effect of such disclosures on voluntary taxpayer compliance.[542] Some might argue that consensual disclosure of return information, in which the taxpayer knowingly consents to the disclosure of his or her return information ("consents"), is less likely to adversely impact taxpayer compliance than adding a nonconsensual provision for the disclosure of taxpayer information.

Currently the Department of Education uses consents to obtain tax information for purposes of its income contingent loan verification program, and does not rely on the statutory

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[539] *Id.* at 455-56.

[540] *Id.* at 456.

[541] *Id.* at 455-56.

[542] S. Prt. No. 103-37 at 54 (1993).

authority to receive that information without consent. The IRS processes over 100,000 consents for this program. Since the IRS is already processing consents for the Department of Education, some would argue that the current practice simply could be extended to financial aid applications.[543]

Critics might argue that the disclosure of sensitive return information of millions[544] of taxpayers to identify the abuse of a few does not strike the appropriate balance between the need to know and the right to privacy. On the other hand, some might argue that since this financial information is already required to be submitted as part of the financial aid form, the infringement on taxpayer privacy is minimal.

Some may argue that if benefits are to be denied if the taxpayer fails to consent to the disclosure of his or her tax information, the consent process may be invalid. It is not clear from the proposal whether financial aid would be denied if consents to the disclosure of tax information were not provided. An amendment to section 6103 to specifically provide for verification could avoid this issue.

Burdens on IRS

In general, the proposal may ease the burden on the financial aid applicant because the applicant will not be required to produce copies of their tax returns for verification of their financial aid applications. The proposal arguably provides simplification for the schools, because the schools will no longer be required to match the information of 30 percent of its applicants. However, because of the financial aid applications are generally filed before the IRS has processed the tax returns for the relevant year, there is likely to be a significant number of cases in which the items reported on the financial aid application will not match the later-filed tax return. Those discrepancies will need to be resolved, thus requiring additional agency, student and taxpayer resources.

The proposal will increase the burden on the IRS as it would have to develop and pay for additional computer systems and personnel to process and track the millions of electronic consents the proposal would require each year and to ensure that each taxpayer did indeed consent to such disclosures.

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[543] In its study on the disclosure of return information, the Department of Treasury noted: "The burden of processing this number of consents obviously would be reduced if the consents were executed and transmitted electronically. Accordingly, the Department of Education has asked to be included in the TDS program." Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (2000) at 92.

[544] The Department of Education seeks access to the return information of approximately 15 million taxpayers each year. The Department of Education receives approximately 10 million applications for student financial assistance each year. Because roughly half of the applicants are dependents, income information is needed for both the student and his or her parents. Thus, verification under this provision could apply to over 15 million taxpayers each year. It is not clear what percentage of applicants submits fraudulent financial aid applications. *Id*.

Prior Action

A similar consent-based proposal was included in the President's fiscal year 2008 proposal. Proposals to amend section 6103 to verify income information of students and parents were contained in the President's fiscal year 2003, 2004, 2005, 2006 and 2007 budget proposals.

C. Transition from the Non-Foreign Cost-of-Living Adjustment to Locality Pay for Employees in Non-Foreign Areas

Present Law

Many employees of executive branch agencies and other offices of the United States Federal government are paid according to the General Schedule (GS).[545] The GS is published annually by the Office of Personnel Management (OPM), and salary rates are set by statutory guidelines in the Federal Employees Pay Comparability Act of 1990 (FEPCA).[546] FEPCA attempts to achieve pay comparability between Federal and non-Federal jobs through a two-part annual pay adjustment: an across-the-board pay adjustment that applies to all employees, and a locality pay adjustment that varies by geographic region within the continental United States.[547] Locality pay adjustments are treated as basic pay for purposes of retirement and other benefits.[548]

Federal employees in the "nonforeign areas" (Alaska, Hawaii, and the U.S. territories of Guam, Puerto Rico, the U.S. Virgin Islands and the Commonwealth of the Northern Mariana Islands) paid according to the GS are not eligible to receive the locality pay adjustment.[549] Instead, these employees are eligible to receive a cost of living adjustment (COLA).[550] The COLA may not exceed 25 percent of an employee's salary; currently, COLA rates range from 10.5 to 25 percent.[551] The COLA is exempt from federal income tax.[552] The COLA is not considered basic pay for purposes of computing retirement benefits.[553]

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[545] 5 U.S.C. sec. 5331-5332.

[546] U.S. Department of Treasury, Postal Service and General Government Appropriations Act of 1991, Pub. L. No. 101-509, sec. 529 (1990).

[547] 5 U.S.C. sec. 5303-5304.

[548] 5 U.S.C. sec. 5304(c)(2)(A). The statute provides that locality pay is part of basic pay for purposes of federal government retirement benefits, life insurance, and premium pay. Generally, Federal Employee Retirement System (FERS) benefits provide a monthly annuity determined by an employee's "high-3." The high-3 refers to an employee's highest average basic pay over any consecutive three-year period. Thrift Savings Plan (TSP) contributions are also determined as a percentage of basic pay, so an increase in basic pay increases the contribution.

[549] 5 U.S.C. sec. 5304(f)(A).

[550] 5 U.S.C. sec. 5941(a)(1). The COLA program was authorized by legislation in 1948 and implemented by Executive Order 10000. 62 Stat. 194, ch. 219, sec. 207; 62 Stat. 1205, ch. 775, sec. 104 (1948); Executive Order 10000, sec. 205 (3 CFR, 1943-1948 Comp., p. 792).

[551] OPM, "Nonforeign Area Cost-of-Living Allowances" (effective September 2007), https://www.opm.gov/oca/cola/rates.asp. The rate is determined by OPM surveys in Washington, D.C. and the nonforeign areas.

OPM statistics from March 2007 estimate that 49,000 Federal and postal service employees in nonforeign areas receive COLA payments; 40 percent of these employees are in Hawaii.[554]

Description of the Proposal

The proposal phases out the COLA and extends locality pay adjustments to Federal employees in nonforeign areas. As under present law, the locality payments are includible in gross income. The shift to locality pay increases the amount of an employee's basic pay for purposes of calculating retirement benefits. The proposal freezes COLA rates as of December 31, 2007 and attempts to phase in a transition to locality pay over seven years.[555] During the transition phase, employees receive a decreasing COLA supplemented by increasing locality pay. Upon full phase-in, employees will receive only locality pay (i.e., the COLA is abolished).[556]

Effective date.–The proposal is effective for the first applicable pay period after January 1, 2008.[557]

Analysis

The proposal puts Federal employees in nonforeign jurisdictions in comparable positions as Federal employees in the contiguous United States for purposes of income inclusion of compensation and for determining retirement benefits.

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[552] 26 U.S.C. sec. 912(2) excludes from taxable income allowances authorized by presidential regulation and paid to government employees in nonforeign areas. This includes the COLA payment, as well as "post differentials," for workers in nonforeign areas that present extraordinarily difficult living conditions. 5 U.S.C sec. 5941(a)(2). Section 912(1) exempts certain types of income paid to federal government employees working overseas, such as allowances paid to Foreign Service officers and Central Intelligence Agency employees for travel and healthcare expenses. Section 912(3) exempts allowances paid to Peace Corps volunteers.

[553] See 5 U.S.C. sec. 8331(3).

[554] OPM, Presentation: "Nonforeign Area Cost of Living Allowance Transformation," January 2008, available at http://www.honolulu-pacific.feb.gov/cola/index.html.

[555] In some cases, the transition period will be longer than seven years.

[556] The legislation proposed by OPM provides rules for calculating the amounts of COLA and locality pay. OPM, Proposed Legislation: "Locality Pay Extension Act of 2007," May 30, 2007, available at http://www.opm.gov/news_events/congress/proposals/Locality_Pay_Extension_Act.pdf.

[557] OPM, Proposed Legislation: "Locality Pay Extension Act of 2007," May 30, 2007, available at http://www.opm.gov/news_events/congress/proposals/Locality_Pay_Extension_Act.pdf.

The proposal raises the question whether Federal employees in Alaska, Hawaii and the affected U.S. territories should be compensated differently than Federal employees in the contiguous United States. The COLA payment was first authorized by legislation passed in 1948, prior to Alaskan and Hawaiian statehood. Subsequent legislation, such as FEPCA, specifically excludes these geographic locations.[558]

The proposal will require employees currently receiving tax-exempt COLA payments to include in income compensation paid under the locality pay system. The tax-exempt nature of the present law COLA payments may attract workers to the nonforeign areas. This incentive is lost under the proposal. However, the increased retirement benefits resulting from the proposal may be attractive to employees, thus alleviating some concern over additional taxes.

The full transition from COLA to locality pay is intended to take seven years. This gradual phase-out will mitigate the reduction in the take home compensation of current employees. However, the transition results in delaying the full benefit for retirement purposes.

Prior Action

A similar proposal was included in the President's FY 2008 Budget. The legislation proposed by OPM to implement this proposal (or legislation that would have a similar effect) has not been introduced in the Congress.[559]

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[558] 5 U.S.C sec. 5304(f).

[559] Legislation has been introduced to include American Samoa in the nonforeign areas that receive COLA payments. H.R. 1786.