PRESENT LAW AND BACKGROUND RELATING TO THE MARRIAGE TAX PENALTY, EDUCATION TAX INCENTIVES, THE ALTERNATIVE MINIMUM TAX, AND EXPIRING TAX PROVISIONS

Scheduled for a Public Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on June 23, 1999

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of the

JOINT COMMITTEE ON TAXATION

June 22, 1999

JCX-39-99

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INTRODUCTION

The House Committee on Ways and Means has announced a series of public hearings on proposals to reduce the tax burden on individuals and businesses. The second day of the series, scheduled for June 23, 1999, includes proposals such as marriage tax penalty relief, education incentives, individual and corporate alternative minimum tax relief, expiring tax provisions, and domestic business tax incentives.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and background information relating to the marriage tax penalty (Part One), tax incentives for education (Part Two), and the individual and corporate alternative minimum tax (Part Three). This document also includes a list of expired and expiring Federal tax provisions (Part Four).

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to the Marriage Tax Penalty, Education Tax Incentives, the Alternative Minimum Tax, and Expiring Tax Provisions* (JCX-39-99), June 22, 1999.

PART ONE: MARRIAGE TAX PENALTY

I. PRESENT LAW AND BACKGROUND

A. Present Law

In general

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus. Although the marginal tax rate breakpoints[2] and the standard deduction are typically considered the major elements of the Federal income tax system that create marriage penalties and bonuses, other provisions of present law also contribute to the amount of marriage penalty or bonus any couple will face.

Marriage penalties due to rate brackets and standard deduction

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. For taxpayers in the 15-, 28-, and 31-percent marginal tax rate bracket, the bracket breakpoints and the standard deduction for single filers are roughly 60 percent of those for joint filers and those for head of household filers are about 83 percent of those for joint filers. For the 36-percent bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket, the bracket breakpoint is $283,150 (for 1999) regardless of filing status.

With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, taxpayers filing joint returns may have some of their taxable income pushed into a higher marginal tax bracket than when they were unmarried. In order for there to be no marriage penalties as a result

[2] A bracket breakpoint is the dividing point between two marginal rate brackets.

of the rate structure and the standard deduction, the bracket breakpoints for married joint filers would have to be at least twice that for both single and head of household filers.

Other marriage penalties and bonuses

Marriage penalties or bonuses will also arise whenever a tax provision exists that has an income-based phase-in or phase-out provision. For any such provision, whether a marriage penalty or a marriage bonus arises will depend on the circumstances of the particular taxpayers and on the income levels at which the phase-out ranges occur for single or head of household taxpayers versus married taxpayers filing jointly. While setting the bracket breakpoints for married taxpayers filing jointly at twice that for singles and head of households would eliminate marriage penalties arising from the rate structure, no such remedy is available with respect to phaseins or phaseouts of tax provisions. The reason for this is that in many instances a tax benefit that is phased in or phased out might be associated with a taxpayer who qualifies for the benefit as a single taxpayer, but when he or she marries another taxpayer their combined income exceeds the level for married joint returns to qualify. This could happen regardless of where the phase-out ranges are set for married joint returns, so long as the other taxpayer had sufficient income to put the combined return over the income limits to qualify for the benefit.

There are many examples of phaseouts and phaseins of tax provisions in the current Federal income tax laws that cause marriage penalties and bonuses.[3] For example, the provision of present law that requires a portion of social security benefits to be included in income can create either a marriage penalty (because it is possible that one spouse's taxable income may require the other spouse's social security benefits to be included in income) or a marriage bonus (because spouses with relatively unequal incomes may have fewer social security benefits included in income than if the spouses were not married).

Marriage penalty for low-income individuals

There are three features of the current Federal individual income tax system that create a marriage penalty for low-income individuals: the variation of the size of the standard deduction by filing status; the phaseout of the earned income credit ("EIC") as income increases; and the variation of the size of the EIC by number of dependent children.

As discussed above, when two unmarried individuals marry, their standard deduction as a married couple is less than the sum of their standard deductions as single taxpayers. For those that take the standard deduction rather than itemize, this produces a marriage penalty because the lower standard deduction means taxable income is correspondingly higher. Because lower

[3] For a complete discussion of various phase-in and phase-out rules, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

income taxpayers are more likely to use the standard deduction, this feature of present law is a more important part of the marriage penalty for lower-income taxpayers relative to higher-income taxpayers.

Even if the marriage penalty caused by the rate structure and standard deduction could be eliminated, other features of present law conditioned on income can still cause either a marriage penalty or bonus. For low-income individuals with dependent children, the EIC is one such feature. Because the EIC increases over one range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EIC for which they are eligible.[4]

Marriage may reduce the size of a couple's EIC not only because their incomes are aggregated, but also because the number of dependent children is aggregated. Because the amount of EIC does not increase when a taxpayer has more than two dependent children, marriages that cause the resulting family to have more than two dependent children will result in a smaller number of children giving rise to the EIC than when their parents were unmarried. Even when each unmarried individual brings just one dependent child into the marriage there is a reduction in the amount of EIC, because the maximum credit for two children is generally much less than twice the maximum credit for one child.

These three features can cause unmarried individuals who are eligible for the EIC to face significant marriage penalties. For example, in 1999, two individuals, each with one dependent child and wage income of $15,000, would face a marriage penalty of $4,460[5] due to the EIC.[6]

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[4] In the case of two individuals with very low wage income, marriage may increase the amount of the EIC available for a dependent child. If the individual with the dependent child is in the phase-in range of the EIC, the aggregation of incomes upon marriage could increase the amount of the EIC.

[5] An individual with $15,000 in wage income would have a regular tax liability of $473 before credits. The $500 nonrefundable child credit would reduce this liability to $0, and the remainder of the credit would go unused because it is a nonrefundable credit. Additionally, an EIC of $1,906 would be allowed, for a net Federal tax liability of -$1,906. If this individual marries another individual in the same circumstances(i.e., one with the same income, dependents, and thus the same tax liability) their regular Federal income tax liability would be $1,770 on their combined income of $30,000, and thus they would be eligible for the full child credit of $1000 for the two children. Additionally, they would receive an EIC of $122, for a net Federal income tax liability of $648. The marriage penalty is thus $648 - (-$1,906 + - $1,906) = $4,460.

[6] The amount of the marriage penalty would have been even larger if each individual had two or more children, for the reasons discussed. This would be mitigated only somewhat by the fact that the resulting family would have 3 or more children and thus be permitted a refundable

B. Legislative History

The marriage penalty in the current income tax rate structure dates from changes in the structure of individual income tax rates in 1969.[7] To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for joint filers and single returns were introduced. Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. Under this tax structure, there was neither a marriage penalty nor a marriage bonus. However, this structure created an incentive to split incomes because, with a progressive income tax rate structure, a married couple with only one spouse earning income could reduce its combined tax liability if it could split the income and assign half to each spouse. While the Supreme Court upheld the denial of contractual attempts to split income,[8] it ruled that in States with community property laws, income splitting was required for community income.[9] As income tax rates and the number of individuals liable for income taxes increased before and during World War II, some States adopted, or considered adopting, community property statutes to give their citizens the tax benefits of income splitting.

The Revenue Act of 1948 provided the benefit of income splitting to all married couples by establishing a separate tax schedule for joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income. (This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.) While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.[10] As a result of this basic rate structure, by 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a "singles penalty" by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about 60 percent of

child credit.

[7] In 1951, a separate rate schedule was created for unmarried heads of household with dependents ("head of household" status). Since the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household.

[8] *Lucas v. Earl*, 281 U.S. 111 (1930).

[9] *Poe v. Seaborn*, 282 U.S. 101 (1930).

[10] Because income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

those for married couples filing joint returns. This schedule created a marriage penalty for some taxpayers.

In 1981, Congress created a deduction for two-earner married couples. The maximum deduction equaled 10 percent of the lesser of: (1) the earned income of the spouse with lower income or (2) $30,000. The two-earner deduction, was, in part, created to alleviate the work disincentive effects of high marginal tax rates on the second earner's income. The Tax Reform Act of 1986 repealed the two-earner deduction in conjunction with the enactment of generally lower tax rates.

II. ANALYSIS

Data relating to marriage penalty under present law

There is no precisely accurate measure of the size of the marriage penalty or bonus under present law. The amount of penalty or bonus that any married couple will face depends on the particular characteristics of the couple's income, deductions, credits, etc., and how such items of income, etc., are assumed to be divided between the spouses.

Under Congressional Budget Office calculations prepared in 1997, the marriage penalty for 1996 under their basic set of assumptions was estimated to be $28.8 billion for 20.9 million returns, and the marriage bonus was estimated to be $32.9 billion for 25.3 million returns. Under this set of assumptions, the 20.9 million returns with a marriage penalty had an average penalty of $1,380 and the 25.3 million returns with a marriage bonus had an average bonus of $1,300. Under a broader measure of penalties and bonuses, the marriage penalty for 1996 was estimated to be $40.2 billion for 23 million returns and the marriage bonus was estimated to be $32.2 billion for 23.9 million returns. Under a third and less broad set of assumptions, the marriage penalty for 1996 was estimated to be $18.1 billion for 18.5 million returns and the marriage bonus was estimated to be $42.2 billion for 27.7 million returns.[11]

Marriage neutrality versus equal taxation of married couples with equal incomes

Any system of taxing married couples requires making a choice among three different concepts of tax equity. One concept is that the tax system should be "marriage neutral;" that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second concept of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. (This second concept of equity could apply equally well to other tax units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.) A third concept of equity is that the income tax

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[11] The basic assumptions assume that spouses divide unearned income and itemized deductions in proportion to their earnings. The first child is assigned to the spouse with higher earnings, the second child to the lower-earning spouse, and all others to the higher earner. If eligible, both spouses can file as head of household and claim the earned income credit. The broader measure is the same as this basic measure except that the spouse with the higher earnings claims all itemized deductions and the lower earner takes the appropriate standard deduction. The least broad measure is the same as the basic measure except that spouses must file single returns and cannot file as head of households. For a complete discussion of the assumptions and analysis, see Congressional Budget Office, *For Better or for Worse: Marriage and the Federal Income Tax*, June 1997 ("CBO, *For Better or Worse*").

should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three. The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally: it specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But it is not marriage neutral.[12] A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity. It should be noted, however, that there is an exception to this rule if refundable credits are permissible. A system with a flat tax rate and a per taxpayer refundable credit would have marriage neutrality, equal taxation of couples with equal incomes, and progressivity.[13]

There is disagreement as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality.[14] Those who hold marriage neutrality to be more important argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

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[12] Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Some married couples would still have marriage bonuses. As described below, the joint return in such a system would allow married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple where one spouse has $60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with $30,000 of income. With progressive taxation, the tax liability on $30,000 would be less than half of the tax liability on $60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

[13] In such a system, the refundability of the tax credit combined with an equal marginal tax rate on all income would make irrelevant any splitting of income between the individuals. Refundability of the tax credit also would create progressivity in what would otherwise be a proportional tax. Such a system could <u>not</u> have standard deductions.

[14] This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax system.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with $20,000 of income are equally well off regardless of whether their income is divided $10,000-$10,000 or $15,000-$5,000. Thus, it is argued, those two married couples should pay the same tax, as they do under present law. By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes.[15]

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, child care, other activities or leisure. It could, of course, be argued in response that the "leisure" of the non-earner may in fact consist of necessary job hunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.

<u>Marriage penalty, labor supply, and economic efficiency</u>

Most analysts discuss the marriage penalty or marriage bonus as an issue of fairness, but the marriage penalty or bonus also may create economic inefficiencies. The marriage penalty or bonus may distort taxpayer behavior. The most obvious decision that may be distorted is the decision to marry. For taxpayers for whom the marriage penalty exists, the tax system increases the "price" of marriage. For taxpayers for whom the marriage bonus exists, the tax system reduces the "price" of marriage. Most of what is offered as evidence of distorted choice is anecdotal. There is no statistical evidence that the marriage penalty or marriage bonus has altered taxpayers' decisions to marry. Even if the marriage decision were distorted, it would be difficult to measure the cost to society of delayed marriages or alternative family structures.

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two

[15] For some recent articles calling into question the justification for joint returns and the assumption of pooling of income among members of a household, see Marjorie E. Kornhauser, "Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return," 45 *Hastings Law Journal* 63 (1993); Edward J. McCaffery, "Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code," 40 *UCLA Law Rev*iew 983 (1993); and Lawrence Zelenak, "Marriage and the Income Tax," 67 *Southern California Law Review* 399 (1994).

unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher <u>marginal</u> tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $6,950 of his earnings would be tax free.[16] However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor. Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[17]

The possible disincentive effects of a higher marginal tax rate on the secondary worker arise in the case of couples who experience a marriage bonus as well. In the specific example above, the couple consisted of one person in the labor force and one person not in the labor force. As noted previously, such a circumstance generally results in a marriage bonus. By filing a joint return, the lower earner may become subject to the marginal tax rate of the higher earner. By creating higher marginal tax rates on secondary earners, joint filing may discourage a number of individuals from entering the work force or it may discourage those already in the labor force from working additional hours.[18]

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[16] As a single taxpayer, the man could claim the standard deduction of $4,300 and one personal exemption of $2,750 for 1999, effectively exempting the first $7,050 of his earnings. This example ignores payroll taxes.

[17] See, Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, 75, March 1985, for a review of econometric studies on labor supply of so-called primary and secondary earners. CBO, *For Better or Worse*, pp. 10-12, also reviews this literature.

[18] The decision to work additional hours may be less sensitive to changes in the marginal tax rate than the decision to enter the labor force. See, Robert K. Triest, "The Effect of Income Taxation on Labor Supply in the United States," *The Journal of Human Resources*, 25, 1990.

Eliminating or reducing the marriage penalty

The marriage penalty could be eliminated in two ways. One is through restructuring of rates (across different filing statuses) and phaseout ranges (for numerous provisions). The other is by giving married couples the option to calculate their tax liability as if they were unmarried.

To eliminate the marriage penalty through a change in the rate structure, the brackets for all unmarried taxpayers (both singles and heads of household) would have to be half as large as the married, filing joint brackets. This change could either gain or lose revenue--depending on whether unmarried individuals have their rate brackets shifted down or joint filers have theirs shifted up. Another effect of such a step would be that single individuals and heads of household with identical incomes would find their tax liabilities nearly the same (they would differ only because of extra personal exemptions for the head of household's dependents and any EIC). Relying solely on extra personal exemptions to adjust for family size would result in unmarried individuals with dependents receiving smaller tax benefits than they now receive by filing as head of household (assuming that the head of household rate is adjusted downward to match the singles rate, rather than the reverse). Such a change in rate structure would also bring back the "singles penalty" that led to the creation of an unmarried filing status (separate from married, filing separately) in 1969.

Allowing joint filers the option of calculating a combined tax liability as if they were not married would eliminate the problem of the marriage penalty at the cost of complicating the tax return. To take advantage of the provision, taxpayers would have to calculate their tax liability under two alternatives and then choose the smaller liability. Rules would have to prescribe how taxpayers would allocate deductions and dependent exemptions (if any) between the two spouses or the spouses could be allowed to allocate them in the most favorable manner. In many cases, it would be difficult for the Internal Revenue Service to enforce detailed rules short of audit; in practice, taxpayers could have wide latitude to allocate deductions and unearned income in the most favorable way.[19]

A second issue for the optional unmarried filing is what filing status to allow taxpayers with dependents to use. Married filers with dependents could be allowed to file as heads of household or permitted only to file as a single taxpayer. If one measures the marriage penalty relative to what tax treatment the spouses would get if they divorced, then head of household filing would be appropriate. If one measures the marriage penalty relative to the tax treatment before the time of marriage, then the answer hinges upon whether the dependents arose before or after the marriage.

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[19] For example, the Virginia State income tax allows separate reporting of income by married couples on a combined tax return, with separate allocations of personal exemptions and deductions as determined by the taxpayer.

An alternative approach would be to reduce the marriage penalty by returning to the 1982-1986 second-earner deduction, which allowed joint filers a deduction for 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000. This approach reduces the marginal tax rate on the lower-earning spouse, but does not eliminate the marriage penalty, especially if the size of the deduction is capped, as was the 1982-1986 deduction. While this approach is not tailored to the particular situation of a married couple, it is much easier to administer than calculating separate liabilities for each spouse. Because it is a deduction, its value rises as the couple's marginal tax rate rises. This feature does not necessarily track the size of the marriage penalty, which is much larger for individuals in the bottom (in relative terms) and top (in dollar amounts) marginal tax brackets. Also, a second-earner deduction provides a tax benefit even if the couple suffers no marriage penalty (i.e., those couples where the earnings are split less evenly than 70/30 as previously discussed).

PART TWO: EDUCATION TAX INCENTIVES

I. OVERVIEW OF PRESENT-LAW TAX INCENTIVES FOR EDUCATION

A. General Tax Treatment of Education Expenses

Individual taxpayers generally may not deduct their education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). 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. 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 deductions, exceed 2 percent of the taxpayer's adjusted gross income ("AGI").

B. Exclusion for Employer-Provided Educational Assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). This exclusion does not apply to graduate-level courses. In order for the exclusion to apply certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special exclusion for employer-provided educational assistance expires with respect to courses beginning after May 31, 2000.

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, and (3) any education involving sports, games, or hobbies.

In the absence of the exclusion under section 127, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only if the education expenses would have been deductible to the employee (if paid by the employee) under section 162. In determining the amount deductible for this purpose, the 2-percent floor on miscellaneous itemized deductions is disregarded.

C. Qualified Scholarships

Present law provides an exclusion from gross income for amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution (sec. 117). This tax-free treatment does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, present law provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations (sec. 117(d)).

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

D. HOPE and Lifetime Learning Credits

1. HOPE credit

Individual taxpayers are allowed to claim a nonrefundable credit, the "HOPE" credit, against Federal income taxes up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The HOPE credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses.[20] The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second

[20] Thus, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the AGI phaseout) for a $1,000 HOPE credit. If an eligible student incurs $2,000 of qualified tuition and related expenses, then he or she is eligible for a $1,500 HOPE credit.

taxable year.[21] The HOPE credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out range will be indexed for inflation.

The HOPE credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the HOPE credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is <u>not</u> entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the HOPE credit or the "Lifetime Learning" credit (described below) with respect to an eligible student.[22]

The HOPE credit is available for "qualified tuition and related expenses," which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the

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[21] The HOPE credit may not be claimed against a taxpayer's alternative minimum tax liability.

[22] The coordination between the HOPE credit, Lifetime Learning Credit, and education IRA provisions is discussed at I.F.2. below.

taxpayer claiming the credit) during the taxable year. The HOPE credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the HOPE credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one-half the normal full-time work load for the course of study the student is pursuing for at least one academic period which begins during the taxable year. To be eligible for the HOPE credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. In order to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

2. Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the "Lifetime Learning" credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000).

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family -- that is, the HOPE credit is computed on a per-student basis, while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns).

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit (rather than repayment of the loan itself).

As with the HOPE credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE credit for that same taxable year with respect to <u>other</u> students. If, for a taxable year, a taxpayer claims a HOPE credit with respect to a student, then the Lifetime Learning credit is <u>not</u> be available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years).[23]

The Lifetime Learning credit is available for "qualified tuition and related expenses," which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program.

In contrast to the HOPE credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses.[24]

As with the HOPE credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer

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[23] The coordination between the HOPE credit, Lifetime Learning Credit, and education IRA provisions is discussed at I.F.2. below.

[24] The HOPE credit is available only with respect to the first two years of a student's undergraduate education.

claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

In addition to allowing a credit for the tuition and related expenses of a student who attends classes on at least a half-time basis as part of a degree or certificate program, the Lifetime Learning credit also is available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student.[25] Undergraduate and graduate students are eligible for the Lifetime Learning credit. Moreover, in contrast to the HOPE credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether or not the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

E. Provisions Relating to Student Loans

1. Deduction for student loan interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit (sec. 221). The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

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[25] Eligible higher educational institutions are defined in the same manner for purposes of both the HOPE and Lifetime Learning credits.

The maximum allowable deduction per taxpayer return is $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter.[26] The deduction is phased out ratably for individual taxpayers with modified AGI of $40,000-$55,000 and $60,000-$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

2. Exclusion of income from student loan forgiveness

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (sec. 108(f)).

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of loans made or refinanced by educational organizations (as well as refinancing loans made by certain tax-exempt organizations) out of private funds, the student's work must fulfill a public service requirement. Cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

[26] The maximum allowable deduction for 1998 was $1,000.

F. Education IRAs

1. In general

Taxpayers may establish certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary ("education IRAs") (sec. 530). Annual contributions to education IRAs may not exceed $500 per designated beneficiary, and may not be made after the designated beneficiary reaches age 18. The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($150,000 and $160,000 for taxpayers filing joint returns); the AGI of the contributor not the beneficiary controls whether a contribution is permitted by the taxpayer. No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

Earnings on contributions to the account generally are subject to tax when withdrawn.[27] However, distributions from an education IRA are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[28]

Tax-free (and penalty-free) transfers or rollovers of account balances from one education IRA benefitting one beneficiary to another education IRA benefitting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the old beneficiary.

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, section

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[27] In addition, education IRAs are subject to the unrelated business income tax ("UBIT") imposed by section 511.

[28] This 10-percent additional tax does not apply if a distribution from an education IRA is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

530(b)(2)(B) specifically provides that qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program for the benefit of the beneficiary of the education IRA.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.

2. Coordination with HOPE and Lifetime Learning credits

If an exclusion from gross income under section 530 is allowed for a particular student, then neither the HOPE credit nor the Lifetime Learning credit will be available in the same taxable year with respect to the same student. However, if a student elects to waive the exclusion from gross income under section 530, then either the student or a parent (if the student is claimed as a dependent by the parent) may claim the HOPE credit or the Lifetime Learning credit.

G. Qualified State Tuition Programs

Present law provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (sec. 529). The term "qualified higher education expenses" has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution[29], as well as certain room and board expenses (i.e., the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

Present law also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational

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[29] "Eligible educational institutions" are defined the same for purposes of education IRAs (described in I.F., above) and qualified State tuition programs.

benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor or another distributee (e.g., when a parent receives a refund) will be included in the contributor's/distributee's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.

A qualified State tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to directly or indirectly direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefitting one designated beneficiary to another account benefitting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family.[30] Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for qualified higher education expenses.

No amount is includible in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any contribution to or earnings on such a program until a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) is includible in the gross income of the distributee. However, to the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f))(1)), the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or Lifetime Learning credit under section 25A with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

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[30] For this purpose, the term "member of the family" means the spouse of the beneficiary and any persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc--and any spouse of such persons.

H. Exclusion of Interest Earned on Education Savings Bonds

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year (sec. 135).[31] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain eligible higher educational institutions (defined in the manner as for the HOPE and Lifetime Learning credits). The amount of qualified higher education expenses taken into account for purposes of the exclusion provided by section 135 is reduced by the amount of such expenses taken into account in determining the HOPE or Lifetime Learning credits claimed by any taxpayer, or an exclusion from gross income for a distribution from an education IRA, with respect to a particular student for the taxable year.

The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1999, the exclusion is phased out for single taxpayers with modified AGI between $53,100 and $68,100 ($79,650 and $109,650 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, present law provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

I. Individual Retirement Arrangements

1. In general

There are two basic types of individual retirement arrangements ("IRAs") under present law: "traditional" IRAs, to which both deductible and nondeductible contributions can be made, and Roth IRAs. The economic benefits of making deductible IRA contributions and making contributions to Roth IRAs are similar,[32] although the rules applicable to each type of IRA contribution vary. IRAs may generally be used to save for any purpose, including educational expenses. In addition, withdrawals used to pay for educational expenses are not subject to the 10-percent early withdrawal tax generally applicable to IRA withdrawals before age 59-1/2.

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[31] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

[32] For a detailed comparison of Roth IRAs and deductible IRAs, see Joint Committee on Taxation *Description and Analysis of Tax Proposals Relating to Individual Savings and IRAs* (JCS-2-97), March 3, 1997.

2. Deductible IRA contributions

Under present law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or the individual's compensation if the individual and the individual's spouse are not active participants in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out for taxpayers with AGI over certain levels for the taxable year.

The AGI phase-out limits for a single individual who is an active participant in an employer-sponsored retirement plan are as follows: for 1999, $31,000 to $41,000; for 2000, 2001 and 2002, the limits increase by $1,000 each year, so that the limits by 2002 are $34,000 to $44,000; for 2003, $40,000 to $50,000; for 2004, $45,000 to $55,000; and for 2005 and thereafter, $50,000 to $60,000.

The AGI phase-out limits for a married individual filing a joint return who is an active participant in an employer-sponsored plan are as follows: for 1999, $51,000 to $61,000; for 2000, 2001 and 2002, the limits increase by $1,000 each year, so that the limits by 2002 are $54,000 to $64,000; for 2003, $60,000 to $70,000; for 2004, $65,000 to $75,000; for 2005, $70,000 to $80,000; for 2006, $75,000 to $85,000; and for 2007 and thereafter, $80,000 to $90,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal 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 AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000. Education expenses that qualify for the exception to the early withdrawal tax are qualified higher education expenses (as defined under the rules relating to qualified State tuition programs) of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer and his or her spouse, at an eligible educational institution. The amount of education expenses is reduced by certain scholarships and similar payments.

3. Roth IRAs

Individuals with AGI 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 $2,000 or the individual's compensation for the year. 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 IRAs generally, a contribution of up to $2,000 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 single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a deductible or nondeductible IRA into an Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over 4 years.

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 5-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies).[33] The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

4. Nondeductible IRA contributions

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. As mentioned above, distributions from a traditional IRA are includible in income and subject to the 10-percent early withdrawal tax (except to the extent the amount distributed is a return of nondeductible contributions).

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[33] Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

J. Tax Benefits for Certain Types of Bonds for Educational Facilities and Activities

1. Tax-exempt bonds

In general

Interest on debt[34] incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103).[35] Like other activities carried out and paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on 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 a private person is taxable unless the purpose of the borrowing is approved specifically in the Internal Revenue Code (the "Code") or in a non-Code provision of a revenue Act.[36] These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments. Present law provides two tests for determining whether a State or local government bond is in substance a private activity bond (sec. 141(b) and (c)).

Private business test.--Private business use and private payments result in State or local government bonds being private activity bonds if both parts of a two-part private business test are satisfied--

(1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and

(2) More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").[37]

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[34] Hereinafter referred to as "State or local government bonds."

[35] Interest on this debt is included in calculating the "adjusted current earnings" preference of the corporate alternative minimum tax.

[36] Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

[37] The 10-percent private business use and payment threshold is reduced to 5 percent for private business uses that are unrelated to a governmental purpose also being financed with

Private loan test.--The second standard for determining whether a State or local government bond is a private activity bond is whether an amount exceeding the lesser of (1) 5 percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether a transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Activities eligible for financing with tax-exempt private activity bonds

The Code includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. These annual volume limits are equal to $150 per resident of the State, or $150 million if greater.[38]

Qualified 501(c)(3) bonds.--Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt bonds ("qualified 501(c)(3) bonds"). Bonds to finance activities of these organizations are not subject to the annual aggregate State volume limits.

Qualified student loan bonds.--States and local governments may issue tax-exempt private activity bonds to finance certain student loans. Eligible student loans include Federally guaranteed loans under the Higher Education Act of 1965 ("GSL loans") and other loans financed as part of a program of general application approved by the State (sec. 144(b)(1)). Non-GSL student loans may be financed with tax-exempt bonds only if no loan under the program exceeds the difference between the total cost of attendance and other forms of student assistance for which the borrower may be eligible.

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proceeds of the bond issue. For example, a privately operated cafeteria in a government office building financed as part of the building's construction could represent a related private business use. On the other hand, a separate, private manufacturing facility financed with proceeds of the same bond issue would constitute an unrelated private business use of bond proceeds.

[38] The annual State private activity bond volume limits are scheduled to increase to the greater of $75 per resident of the State or $225 million in calendar year 2007. The increase will be phased in ratably beginning in calendar year 2003. This increase was enacted by the Tax and Trade Relief Extension Act of 1998.

Other tax-exempt private activity bonds.--States or local governments may issue tax-exempt exempt-facility bonds to finance property for certain private businesses. Business uses generally eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing is authorized for capital expenditures for certain manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), certain local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Finally, in addition to student loans, certain non-business private housing may be financed with proceeds of these bonds: (1) mortgage loans for first-time home buyers satisfying moderate income and home purchase price requirements, and (2) mortgage loans generally for certain pre-1977 veterans who purchase homes in any of the five States that historically have authorized issuance of these bonds.[39]

Private activity tax-exempt bonds may not be used to finance schools for private, for-profit businesses.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

The Code includes three exceptions applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds

[39] The five States are Alaska, California, Oregon, Texas, and Wisconsin.

of the bonds are spent for the purpose of the borrowing within six months after issuance.[40] Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.[41] Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.[42]

2. Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, certain States and local governments are given the authority to issue "qualified zone academy bonds." Under present law, a total of $400 million of qualified zone academy bonds may be issued in each of 1998 and 1999. The $400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line.[43] Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by Treasury

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[40] In the case of governmental bonds (including bonds to finance public schools) the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

[41] Retainage amounts are limited to no more than 5 percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued. Issuers qualifying for this "construction bond" exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

[42] The Small Business Job Protection Act of 1996 permitted issuance of the additional $5 million in public school bonds by small governments. Previously, small governments were defined as general purpose governments that issued no more than $5 million of governmental bonds, without regard to the purpose of the financing.

[43] See, Rev. Proc. 98-9, 1998-3 I.R.B. 56, which sets forth the maximum face amount of qualified zone academy bonds that was permitted to be issued for each State during 1998.

Department regulation at 110 percent of the applicable Federal rate for the month in which the bond is issued) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate each month at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond issued in a given month also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Such present value is determined using as a discount rate of the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

"Qualified zone academy bonds" are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy;" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in one of the 31 designated empowerment zones or one of the 95 designated enterprise communities, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

II. BACKGROUND DATA ON COLLEGE ENROLLMENT AND COSTS

Since 1990, more than 14 million students have enrolled annually in post-secondary education or training programs, with approximately 75 percent enrolled in public institutions and 25 percent in private institutions in 1995. The full-time equivalent enrollment has exceeded 10 million in every year since 1991. Of all those enrolled in 1995, 61 percent were enrolled in four-year institutions. From the average high school sophomore class in 1980, 66.4 percent had enrolled in some form of post-secondary education or training program by 1992. During this period, 7.9 percent had attained an associate's degree, 20 percent had attained a bachelor's degree, 2.7 percent had attained a master's degree, and 1.1 percent had attained a doctorate or professional degree.[44]

In every year since 1981, the costs of attending a two- or four-year college have risen faster than the rate of inflation; by contrast, in the late 1970s, college costs lagged behind inflation. Table 1 below details average tuition and fees by type of college in both current and constant (inflation adjusted) dollars since 1986. Since 1976, college tuition and fees generally have risen 70 percent more than the economy's overall price level. For the 1976-77 academic year, the total cost[45] of attending a four-year private college averaged $3,906 (tuition and fees of $2,534) and the total cost of attending a four-year public college averaged $1,935 (tuition and fees of $617). For the 1986-87 academic year, the comparable total cost figure had risen to $10,039 (tuition of $6,658) for a four-year private college and to $4,138 (tuition of $1,414) for a four-year public college. By the 1996-97 academic year, the comparable total cost figure had risen to $18,476 (tuition and fees of $12,920) for a four-year private college and to $7,331 (tuition and fees of $2,986) for a four-year public college. For the 1996-97 academic year, the average cost of tuition and fees at a two-year public college was $1,283.[46]

Over the past decade, governmental funding of higher education has declined as a share of total funding. Table 2 reports the revenues of all institutions of higher education by source. The table documents that, as a percentage of all revenues, Federal funds have remained relatively constant while State and local funding has declined. As a percentage of all revenues, tuition and fees have increased while other private funding has increased modestly. As Table 2 details, State and local contributions have not declined in dollar terms, though their total growth over the

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[44] Department of Education. National Center for Education Statistics, *Digest of Education Statistics 1997*.

[45] "Total cost" includes tuition and fees, and on-campus room and board costs.

[46] Department of Education. National Center for Education Statistics, *Digest of Education Statistics 1997*.

period 1986-87 to 1994-95 was only 7 percent more than would be accounted for by inflation, while full-time equivalent fall enrollment at public institutions increased 14.4 percent.

Table 1.–Average Undergraduate Tuition and Fees, 1986-87 Through 1996-97

	Current dollars				Constant 1996 dollars			
Year	Private four-year	Private two-year	Public four-year	Public two-year	Private four-year	Private two-year	Public four-year	Public two-year
1986-1987	6,658	3,684	1,414	660	9,361	5,179	1,988	928
1987-1988	7,116	4,161	1,537	706	9,629	5,630	2,080	955
1988-1989	7,722	4,817	1,646	730	10,000	6,239	2,132	945
1989-1990	8,396	5,196	1,780	756	10,345	6,402	2,193	931
1990-1991	9,083	5,570	1,888	824	10,679	6,549	2,220	969
1991-1992	9,775	5,752	2,119	937	11,094	6,528	2,405	1,063
1992-1993	10,294	6,059	2,349	1,025	11,342	6,676	2,588	1,130
1993-1994	10,952	6,370	2,537	1,125	11,742	6,829	2,719	1,206
1994-1995	11,481	6,914	2,681	1,192	11,985	7,218	2,798	1,245
1995-1996	12,243	7,094	2,848	1,239	12,421	7,198	2,889	1,257
1996-1997	12,920	7,190	2,986	1,283	12,774	7,109	2,953	1,269

Notes: Current dollar figures are adjusted to constant dollars by reference to the average CPI of the calendar years spanned by the acacemic year for which the tuition is reported.

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 1997.*

Table 2.–Current Funds and Revenues of All Institutions of Higher Education By Source, Selected Years, 1986-1987 Through 1994-1995

[amount in millions]

Year	Tuition and fees		State and local sources		Federal sources		Other sources		Total
	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	
1986-1987	25,706	23.6	34,109	31.3	14,239	13.0	35,091	32.2	109,145
1990-1991	37,434	25.0	43,412	29.0	18,236	12.2	50,684	33.8	149,766
1994-1995	51,506	27.2	49,509	26.2	23,243	12.3	64,863	34.3	189,121

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 1997.*

III. ECONOMIC ANALYSIS

A. The Economics of Subsidizing Education

Overview of the goals of subsidies

All levels of government make substantial direct expenditures to subsidize post-secondary education. In addition, private educational organizations channel gifts from private persons into subsidies for the education of other persons. By exempting such organizations from income tax and permitting the gifts to such organizations to be deductible, additional implicit subsidies under the Internal Revenue Code are created for education. Other subsidies for education provided by the Internal Revenue Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the HOPE and Lifetime Learning credits, the deferral of tax on the earnings of contributions to qualified State tuition programs, and the exclusion from income of earnings on education IRAs and of the interest on U.S. savings bonds used to pay for post-secondary education.[47] Analysts attempt to evaluate subsidies in terms of their efficiency, equity, and administrability. In this regard, subsidies to post-secondary education have been argued to improve both economic efficiency and to promote economic equity.

Efficiency as a goal of subsidies to education

Economists generally have a predilection for favoring the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a "positive externality."[48]

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[47] Certain income limits restrict some benefits. Part I, above, describes tax benefits under present law that subsidize education.

[48] For a more complete discussion of the notion of "positive externality," see Harvey S. Rosen, *Public Finance* (Homewood, Illinois: Irwin), 1988, pp. 142-146. Rosen discusses the notion of positive externality as applied to education. Rosen notes (pp. 144-145), "That college increases productivity may be true, but *as long as the earnings of college graduates reflect their*

On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society's perspective total reduction in the rate of infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too few of the vaccinations. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages,[49] many people have long believed that education also produces positive externalities. Commentators argue that society functions better with an educated populace and that markets function better with educated consumers. They observe that education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as the single individual does not appreciate the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, without some empirical analysis of the social benefits that would arise from creating new subsidies, it is not possible to say whether such subsidies would increase or decrease economic efficiency.

Some observers note that, aside from potential spillover effects that education might create, the market for financing education may be inefficient. They observe that while investors in housing or other tangible assets have property that can be pledged to secure financing to

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higher productivity, there is no externality [Rosen's emphasis]."

[49] Kevin Murphy and Finis Welch, "Wage Premiums for College Graduates: Recent Growth and Possible Explanations," *Education Researcher*, 18, May 1989, pp. 17-26. Murphy and Welch document that, between 1981 and 1986, the average wage of workers with 16 years of schooling was 58.4 percent higher than the average wage of workers with 12 years of schooling. This college wage premium represented the largest such premium during the period of their study, 1963 through 1986.

procure the asset, an individual cannot generally pledge his or her future earnings as security for a loan to obtain education or training designed to increase the individual's future earning potential. This inability to provide security for education loans constrains borrowing as an alternative to finance education for some taxpayers. Taxpayers who cannot borrow to finance education or training may forgo the education or training even though it would produce a high return for the investor. This inefficiency in the market for education finance may offer a justification for public subsidies. The inefficiency in the market for financing is likely most acute among lower-income taxpayers who generally do not have other assets that could be pledged as security for an education loan. This suggests that this potential source of market inefficiency also relates to the considerations of equity as a rationale for subsidies of education (discussed below).

Equity as a goal of subsidies to education

As noted above, there is evidence indicating that education and training are rewarded in the market place. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that even if there were no positive externalities from education, promoting economic equity within a market economy provides a basis for subsidizing education.[50] If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

B. Treatment of Education Expenses Under an Income Tax

Educational expenditures

Students and their families incur direct educational expenses when they pay tuition and fees. Federal, State, and local governments and private persons make expenditures on behalf of students by funding State and local and private educational institutions.[51] Such expenditures by governments or private persons are equivalent to the government or private person transferring funds to the student which the student subsequently pays over to the educational institution.

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[50] For a cautionary note on the importance of the subsidy given, see Dennis Zimmerman, "Expenditure-Tax Incidence Studies, Public Higher Education, and Equity," *National Tax Journal*, 26, March 1973. Zimmerman finds that the subsidy structure can just as easily promote a less equal distribution of lifetime income.

[51] Table 2 reports that Federal, State and local, and private expenditures accounted for 72.8 percent of post-secondary educational revenues for the 1994-95 academic year. Tuition accounted for 27.2 percent.

Lastly, students incur implicit expenditures for education by choosing schooling over the alternative of taking a job and earning a wage. The time spent in school means forgone income. Alternatively viewed, it is as if the student worked, was paid, and used the wages to purchase education. Analysts have concluded that the largest cost of obtaining an education come from forgone wages.[52]

Post-secondary education helps individuals develop general analytic and reasoning skills (e.g., problem solving) and often job specific skills (e.g., nursing training) that enhance the student's ability to earn a future income. In this way, expenditures on education are like an investment in a capital good: an outlay is made in the present for a machine that will produce income over a number of years in the future. It is because of this similarity that economists often refer to expenditures on education as investment in "human capital." However, some part of expenditures on post-secondary education are not as obviously investments in human capital but are more like consumption. For example, the chemical engineering student who takes an elective course in the history of music probably would not find her future earning potential increased by that particular elective. It is difficult to determine for any given student what portion of post-secondary education represents consumption and what portion represents investment in human capital.

The distinction between education as investment and education as consumption is not important to the efficiency/externality rationale for providing a subsidy to education, as externalities can arise from either consumption or investment. However, the distinction between education as investment and education as consumption is important to the equity rationale for providing a subsidy to education, as the equity rationale generally is based upon education as an investment in future earning potential. The distinction between education as investment and education as consumption also is important for analysis of the income tax treatment of expenditures on education--that is, should education expenses be deductible to properly measure a taxpayer's net income?

Educational expenses under a theoretical income tax

Under a theoretical income tax, any expenditures undertaken in the present for returns that are expected in the future should be capitalized and recovered as the future returns are earned. Consumption expenditures are neither deductible nor amortizable under a theoretical income tax. Thus, certain expenditures on education should be capitalized by the taxpayer and recovered against future earnings. As discussed above, the relevant expenditures to be

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[52] See Michael J. Boskin, "Notes on the Tax Treatment of Human Capital," in Department of the Treasury, *Conference on Tax Research, 1975* (Washington, D.C.: Department of the Treasury), 1977, pp. 185-195.

capitalized would only be those that represent investments in human capital,[53] not those related to consumption. Of course, making such decisions would be quite difficult in practice. For example, the would-be chemical engineer of the example above may not know whether her future employment will be in the chemical industry or perhaps as a chanteuse, making it difficult to know how to account for the costs of the chemical engineering courses and the music course. Many educational expenses are paid by a parent on behalf of a student. In such case, the theoretical income tax would permit amortization only by the student.

Educational expenses under the present-law income tax

As discussed above, there are three types of expenditures made by students on their education: (1) payment via implicit or explicit transfers received from governments or private persons; (2) forgone wages; and (3) direct payment of tuition and other educational expenses by the student.

By not including the transfers from governments or private persons in the income of the student, present law offers the equivalent of expensing of those expenditures undertaken on behalf of the student by governments and private persons.[54] This treatment (the equivalent of expensing) also is provided for direct transfers to students in the form of qualified scholarships or employer-provided educational assistance, which are excludable from income. Similarly, because forgone wages are never earned, the implicit expenditure incurred by students forgoing present earnings also receives expensing under the present-law income tax.

The present-law treatment of direct payment of tuition and other educational expenses by the student is subject to various tax treatments. With certain exceptions, the present-law income tax treats direct payments of tuition and other educational expenses as consumption, neither deductible nor amortizable.[55] An important exception to this treatment is expenses that qualify

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[53] For a discussion of government policy towards human capital investment, see C. Eugene Steuerle, "How Should Government Allocate Subsidies for Human Capital?" American Economic Review, 86, May 1996, pp. 353-357.

[54] Of course, the actual government expenditures themselves represent a wealth transfer to the student. It is only the income tax treatment of such expenditures (that is, not counting them as income to the student) that is the equivalent of expensing.

[55] Exceptions include the direct payment of education expenses with earnings from education IRAs or interest earned on U.S. savings bonds by low- and middle-income taxpayers. Such payments are permitted an exclusion from income tax. By not counting such interest or earnings in income, they (the earnings components, but not the principal) are afforded treatment equivalent to expensing. Other tax benefits for direct expenditures on education expenses, such as the deductibility of certain interest expense or penalty free withdrawals from IRAs, provide

for the HOPE credit or the Lifetime Learning credit. The HOPE credit provides income tax treatment that is the equivalent of an investment tax credit for educational expenditures that qualify for the credit. For the first $1,000 of qualified expenditures, a taxpayer receives a $1,000 credit, which is the equivalent of a 100-percent investment tax credit. Such 100-percent investment tax credit is more generous tax treatment than is expensing. A 100-percent investment tax credit is, from the taxpayer's perspective, preferred to expensing because it permits a deduction from taxes owed, rather than a deduction from taxable income itself. Thus, a 100-percent credit allows a dollar-for-dollar credit against taxes owed, whereas the value of a deduction from taxable income depends on the taxpayer's marginal tax rate.[56] For the next $1,000 of expenditures, the taxpayer receives the equivalent of a 50-percent investment tax credit. The Lifetime Learning credit is the equivalent of a 20-percent investment tax credit on qualified expenditures.

The theoretical income tax would have all expenditures toward investment in human capital capitalized and recovered against the student's future earnings. By permitting the equivalent of expensing for the indirect expenditures related to a student's education (and direct expenditures made in the form of qualified scholarships or employer-provided education assistance), the present-law income tax subsidizes investment in human capital relative to investment in physical capital.[57] For direct expenditures by the student, for those that qualify for the HOPE credit, the treatment of the first $2,000 on qualified educational expenses in the first two years of post-secondary education provides greater subsidy than that provided for investment in physical capital.[58] Though certain educational expenses are thus afforded income tax

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only minor benefits in comparison to expensing or amortization treatment of the full amount of education expenses.

[56] Specifically, the cost to the taxpayer of a dollar of expenditure on education that is permitted to be deducted is $(1-t)$ times the amount of the expenditure, where t is the taxpayer's marginal tax rate. For a taxpayer in the 28-percent tax bracket, a thousand dollar expenditure on education that is permitted to be deducted is only $720 (the tax benefit of the deduction is thus $280). If the taxpayer is allowed a credit for the thousand dollar expenditure, there is no cost to the taxpayer of the thousand dollar expenditure (that is, the tax benefit is the full $1,000). In general, a taxpayer will prefer expensing treatment if his or her marginal tax rate exceeds the percentage value of the credit.

[57] Expensing is more generous cost recovery than is capitalization and amortization. Under simplifying assumptions, the expensing of investment is economically equivalent to the nontaxation of the returns to that investment. Amortization attempts to measure, and tax annually, the return to the investment.

[58] Additionally, the Lifetime Learning credit provides a subsidy whose value in relation to expensing will vary depending on the marginal tax rate of the taxpayer. A taxpayer in a marginal rate bracket in excess of the value of the credit (20 percent under present law) would

treatment that is as favorable or more favorable than expensing, the present-law income tax generally permits no recovery of the direct tuition or other educational costs paid by the student that do not qualify for the HOPE or Lifetime Learning credits.[59] On balance, the variety and complexity of educational benefits afforded through the tax code, when coupled with expenditures that do not receive favorable tax treatment, make it difficult to determine the extent to which educational expenditures are subsidized by the tax code, relative to investments in physical capital.

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prefer expensing of such expenditures, whereas a taxpayer with a marginal rate bracket less than the value of the credit would prefer the present credit to expensing.

[59] As noted previously, exceptions include the direct payment of education expenses with earnings from education IRAs or interest earned on U.S. savings bonds by low- and middle-income taxpayers. Again, it is only the earnings from such accounts, not the principal, that is afforded the favorable tax treatment.

PART THREE: ALTERNATIVE MINIMUM TAX

I. INDIVIDUAL ALTERNATIVE MINIMUM TAX

A. Present Law

In general

Present law imposes a minimum tax ("AMT") on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. The AMT is imposed on individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent on the remaining AMTI. The exemption amount is: $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount that the individual's AMTI exceeds a threshold amount. The threshold amount is: $150,000 in the case of married individuals filing a joint return and surviving spouses; $112,500 in the case of other unmarried individuals; and $75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the $175,000 break-point amount are not indexed for inflation. The lower capital gains rates applicable to the regular tax apply for purposes of the AMT.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

Preference items in computing AMTI

The minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

(5) Forty-two percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter, farm, or passive activities are denied.[60]

Adjustments in computing AMTI

The adjustments that individuals must make in computing AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) Miscellaneous itemized deductions are not allowed.

(6) Itemized deductions for State, local, and foreign real property taxes; State and local personal property taxes; and State, local, and foreign income, war profits, and excess profits taxes are not allowed.

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[60] Given the passage of section 469 by the Tax Reform Act of 1986 (relating to the deductibility of losses from passive activities), these provisions are largely "deadwood."

(7) Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income.

(8) Standard deductions and personal exemptions are not allowed.

(9) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period.

(10) The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a 10-year period.[61]

(11) The regular tax rules relating to incentive stock options do not apply.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's AMT liability by more than 90 percent of the amount determined without these items.

The various nonrefundable credits allowed under the regular tax generally are allowed only to the extent that the individual's regular tax exceeds the tentative minimum tax. The earned income credit and the child credit of those taxpayers with three or more qualified children are refundable credits and may offset the taxpayer's tentative minimum tax. However, a taxpayer must reduce these refundable credits by the amount the taxpayer's tentative minimum tax exceeds his or her regular tax liability.[62]

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax in such subsequent year. For individuals, the AMT credit is allowed only to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature. Most individual AMT adjustments relate to itemized deductions and personal exemptions and are not timing in nature.

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[61] No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

[62] For 1998 only, the nonrefundable personal credits were not limited by the tentative minimum tax, and the refundable child credit was not reduced by the minimum tax.

B. Data on the Individual Minimum Tax

Data on taxpayers affected by the AMT

Relatively few individuals have been subject to the AMT in the past. However, the number of individuals taxpayers subject to the AMT is projected to increase significantly in the future. This is expected to occur because of the absence of inflation indexing in the calculation of the minimum tax exemption amounts. Table 3 presents individual AMT data and projections for the 1987-2009 tax years.

Table 3.–Individual Income Tax Returns With Tax Liability Under the Individual Alternative Minimum Tax, 1987-2009, Actual and Projected

Year	Number of returns paying AMT (millions)	Percentage of filed returns paying AMT	Excess of AMT liability over regular tax liability ($billions)
1987	0.140	0.1	1.7
1988	0.134	0.1	1.0
1989	0.117	0.1	0.8
1990	0.132	0.1	0.8
1991	0.244	0.2	1.2
1992	0.287	0.3	1.4
1993	0.335	0.3	2.1
1994	0.369	0.3	2.2
1995	0.414	0.4	2.3
1996	0.478	0.4	2.8
1997	data not available	data not available	data not available
1998	data not available	data not available	data not available
1999	0.823	0.6	3.6
2000	0.942	0.7	3.8
2001	1.170	0.9	4.3
2002	1.402	1.1	4.9
2003	1.834	1.4	5.7
2004	2.411	1.8	6.9
2005	3.075	2.3	8.3
2006	4.085	3.0	10.2
2007	5.412	3.9	12.9
2008	6.918	4.9	15.8
2009	9.043	6.3	19.8

Note: These statistics represent taxpayers who actually pay AMT and do not include taxpayers whose regular tax liabilities are affected by the AMT through tax credit limitations. See Tables 7, 8, and 9 for such data.

Source: Internal Revenue Service, *Statistics of Income*, 1987-1996; projections for years 1999-2009 from Joint Committee on Taxation Staff estimates.

Tables 4 and 5 below report how individual AMT taxpayers are estimated to be distributed across various income classes in 2000 and 2008.

Table 4.--Distribution of Individual AMT Taxpayers with AMT Liability under Present Law, 2000

Income category[1]	Number of returns (thousands)	AMT taxpayers as a percentage of all taxpayers
Less than $10,000	(2)	(3)
$10,000 to less than $20,000	1	(3)
$20,000 to less than $30,000	2	(3)
$30,000 to less than $40,000	15	0.1
$40,000 to less than $50,000	15	0.1
$50,000 to less than $75,000	79	0.4
$75,000 to less than $100,000	135	1.3
$100,000 to less than $200,000	300	3.5
$200,000 and over	389	15.1
Total (all taxpayers)	**937**	**0.7**

(1) The income concept used to place tax returns into income categories is AGI plus: (a) tax-exempt interest; (b) employer contributions to health plans and life insurance; (c) employer share of FICA tax; (d) workers compensation; (e) nontaxable Social Security benefits; (f) insurance value of Medicare benefits; (g) AMT preference items; and (h) excluded income of U.S. citizens living abroad. Categories are measured at 1999 levels. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income, resulting in differences with Table 3.

(2) Less than 500.

(3) Less than .05 percent.

Details may not add to totals due to rounding.

Source: Staff of the Joint Committee on Taxation.

Table 5.--Distribution of Individual AMT Taxpayers with AMT Liability under Present Law, 2008

Income category[1]	Number of returns (millions)	AMT taxpayers as a percentage of all taxpayers
Less than $10,000	0.001	(2)
$10,000 to less than $20,000	0.001	(2)
$20,000 to less than $30,000	0.014	0.1
$30,000 to less than $40,000	0.114	0.6
$40,000 to less than $50,000	0.170	1.2
$50,000 to less than $75,000	1.060	4.4
$75,000 to less than $100,000	1.661	12.3
$100,000 to less than $200,000	2.568	22.9
$200,000 and over	1.319	40.6
Total (all taxpayers)	**6.906**	**4.6**

(1) Same income concept as used in Table 4, measured at 1999 levels.
(2) Less than .05 percent.
Details may not add due to rounding.
Source: Staff of the Joint Committee on Taxation.

The increase in the number of taxpayers subject to the AMT largely can be attributed to the fact that the personal exemptions, standard deduction, and tax bracket break points of the regular tax are indexed for inflation, while the AMT exemption amounts and tax bracket break point are not indexed for inflation. Proposals that would increase or index these amounts would decrease the number of taxpayers subject to the AMT and reduce the tax burden of those individuals otherwise subject to the AMT.[63] Even with indexing, one would expect some growth in AMT taxpayers as real (i.e., inflation-adjusted) incomes rise over time.

[63] Both the House- and Senate-passed versions of H.R. 2014, the "Taxpayer Relief Act of 1997," would have increased or indexed the exemption amounts of the individual AMT. However, the final conference agreement on H.R. 2014 as passed by the Congress and signed by the President, did not contain any provision to change the AMT exemption amounts (P.L. 105-34, August 5, 1997).

The lack of indexing in the AMT also explains the increase of AMT taxpayers in the middle-income categories. Under present law, the relatively large AMT exemption amounts[64] shelter most of a low- or middle-income taxpayer's AMTI from tax. However, over time, with inflation, a taxpayer's income is expected to grow in nominal dollars. Most of this inflated income of a middle-income individual will remain subject to tax at a 15-percent rate for regular tax purposes because the personal exemptions, standard deduction, and tax bracket break points of the regular tax are indexed for inflation. However, for AMT purposes, relatively less of the taxpayer's inflated income will be sheltered by the unindexed AMT exemption amount and the amount not sheltered will become subject to the higher AMT rate of 26 percent. Because the AMT exemption amounts are phased out over relatively high levels of AMTI, indexing these amounts would provide benefits to taxpayers in all income classes.[65]

Table 6 demonstrates the results if the AMT exemption amounts were indexed for inflation, starting in 1999. With indexing, the number of taxpayers subject to AMT and the amount of AMT collected is expected to remain relatively constant.

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[64] The exemptions amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return.

[65] The phase-out ranges are $150,000 to $330,000 of AMTI for married individuals filing a joint return and surviving spouses; $112,500 to $262,500 of AMTI for other unmarried individuals; and $75,000 to $165,000 of AMTI for married individuals filing singly.

Table 6.--Projected Individual Income Tax Returns With Tax Liability Under the Individual AMT If Exemptions Were Indexed, 1999-2008

Year	Number of returns paying AMT (millions)	Percentage of filed returns paying AMT	Excess of AMT liability over regular tax liability ($billions)
1999	0.747	0.6	3.4
2000	0.723	0.6	3.4
2001	0.758	0.6	3.6
2002	0.769	0.6	3.7
2003	0.775	0.6	3.8
2004	0.818	0.6	4.1
2005	0.851	0.6	4.4
2006	0.887	0.7	4.7
2007	0.941	0.7	5.2
2008	0.958	0.7	5.5
2009	1.016	0.7	5.9

Source: Staff of the Joint Committee on Taxation.

As described above, the AMT acts as a floor with respect to the utilization of nonrefundable credits in that a taxpayer is allowed to reduce his or her regular tax liability with otherwise allowable credits only to the extent the taxpayer's regular tax exceeds his or her tentative minimum tax. Tables 7, 8, and 9, below, demonstrate the estimated effects of the AMT on all nonrefundable tax credits, the child credit, and the education credits, respectively. Projections on the child and education credits are provided because these credits were only recently enacted by the Congress in 1997. These credits significantly increased the number of taxpayers eligible for nonrefundable credits, and they were targeted toward taxpayers with middle incomes.

Consistent with the projections in Table 3, relatively few taxpayers currently have tax credit utilization that is limited because of the AMT. However, over time, the number of taxpayers subject to this limitation is expected to increase. This pattern is consistent with the expected increase in the number of AMT taxpayers.

Table 7.--Projected Individual Income Tax Returns With Nonrefundable Tax Credits, 2000 and 2008

(in millions)

	Taxable year 2000	Taxable year 2008
Returns with nonrefundable credits	46.9	49.0
Returns receiving full credits	18.2	15.1
Returns receiving zero or less than full credits	28.7	33.9
Returns affected by the AMT	1.1	6.0

Source: Staff of the Joint Committee on Taxation.

Table 8.--Projected Individual Income Tax Returns With Child Credits, 2000 and 2008[1]

(in millions)

	Taxable year 2000	Taxable year 2008
Returns with dependents under age 17	39.4	40.6
Returns receiving full child credit	20.5	15.8
Returns receiving zero or less than full child credit	18.9	24.8
Returns affected by the AMT	0.6	5.0

[1] Includes refundable portion of the credit.

Source: Staff of the Joint Committee on Taxation.

Table 9.--Projected Individual Income Tax Returns With HOPE and Lifetime Learning Credits, 2000 and 2008

(in millions)

	Taxable year 2000	Taxable year 2008
Returns with tuition expense	15.2	16.1
Returns receiving full education credit	5.7	5.1
Returns receiving zero or less than full education credit	9.5	11.3
Returns affected by the AMT	0.5	1.8

Source: Staff of the Joint Committee on Taxation.

C. Complexity of the Individual Minimum Tax

The AMT requires a calculation of a second income tax base and computation of a tax on that base, so the present tax system, with an AMT, is not as simple to administer or comply with as the same system would be without an AMT. Relatively few taxpayers currently are subject to the AMT.[66] However, the data on taxpayers subject to the AMT understates the extent to which the AMT imposes a compliance burden on taxpayers. Many taxpayers must calculate whether, in fact, they are liable for the AMT or whether the utilization of certain credits is limited by the AMT. The IRS has provided a 12-line worksheet to see if the taxpayer needs to fill in the AMT Form 6251. In addition, the IRS instructions instruct the taxpayer to fill in Form 6251 if the taxpayer has any of 13 listed preferences. The Form 6251 itself contains 50 lines to compute the minimum tax. In addition, taxpayers claiming credits must fill out worksheets to see if their credits are limited by the AMT.

The projections in Table 3, above, show that many more individuals will be subject to or otherwise affected by the AMT in the future. Thus, more individuals will face the added complexity of the AMT in the future. This increase in number of taxpayers affected by the AMT occurs because the exemption amount and the tax bracket break point for the AMT are not indexed for inflation.

There are no studies that specifically measure compliance costs arising from the individual AMT. Indirect evidence of the complexity imposed by the individual AMT may be the increased utilization of the services of paid tax preparers by individual taxpayers subject to

[66] See Table 3, above.

the individual AMT. If taxpayers subject to the AMT are more likely to have complicated financial affairs, they might use paid tax preparers even in the absence of the AMT. However, Tables 4 and 5 indicate that middle-income taxpayers, whose financial affairs are less likely to be complicated, are more likely to become subject to the AMT in the future and thus may be faced with more complicated tax compliance burdens.

II. CORPORATE ALTERNATIVE MINIMUM TAX

A. Present Law

In general

Present law imposes a minimum tax on a corporation to the extent the corporation's minimum tax liability exceeds its regular tax liability. This alternative minimum tax ("AMT") is imposed on corporations at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a $40,000 phased-out exemption amount. The exemption amount is phased-out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds $150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less that $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first 3-taxable year period.

Preference items in computing AMTI

The corporate minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Adjustments in computing AMTI

The adjustments that corporations must make in computing AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) The special rules applicable to Merchant Marine construction funds are not applicable.

(6) The special deduction allowable under section 833(b) Blue Cross and Blue Shield organizations is not allowed.

(7) The adjusted current earnings adjustment, described below.

Adjusted current earning ("ACE") adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings ("ACE") of a corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction. In determining ACE the following rules apply:

(1) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.

(2) Any amount that is excluded from gross income under the regular tax but is included for purposes of determining earnings and profits is included in determining ACE.

(3) The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).

(4) Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.

(5) The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.

(6) Inventory must be calculated using the FIFO, rather than LIFO, method.

(7) The installment sales method generally may not be used.

(8) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(9) Depletion (other than for oil and gas) must be calculated using the cost, rather than the percentage, method.

(10) In certain cases, the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's tentative minimum tax by more than 90 percent of the amount determined without these items.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT.

If a corporation is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year.[67]

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[67] The AMT credit also includes certain credits disallowed under sections 29 (relating to nonconventional fuels) and 30 (relating to electric vehicles).

B. Legislative Background

The corporate AMT was enacted by the Tax Reform Act of 1986 to ensure that no corporation with substantial economic income could avoid significant tax liability by using exclusions, deductions and credits.[68] The tax was effective beginning in 1987 and the ACE adjustment described under present law was effective beginning in 1990, replacing a book income adjustment that was in effect for 1987-1989.

Since the enactment of the corporate AMT, several changes to the tax have been made. The principal changes involve the computation of depreciation. The ACE depreciation adjustment requiring the use of straight-line depreciation for tangible personal property was repealed by the Omnibus Budget Reconciliation Act of 1993, for property placed in service after 1993. The Taxpayer Relief Act of 1997 ("the 1997 Act") allowed the use of regular tax ACRS lives in computing AMT depreciation for property placed in service after 1998.

Other changes include the repeal of the oil and gas preferences for percentage depletion and intangible drilling costs for corporations other than integrated oil companies by the Energy Policy Act of 1992. The 1997 Act repealed the corporate AMT for small corporations. Numerous other smaller changes have been made to the corporate AMT since its enactment in 1986.

C. Analysis of Issues

1. Background

As the preceding discussion suggests, the Congress has made substantial revisions to the corporate AMT since its enactment. Under prior law prior law, larger firms were more likely to be subject to the AMT than were smaller firms and firms in more capital intensive industries were more likely to be subject to the AMT than were firms in less capital intensive industries. This outcome would be expected by the design of the prior-law AMT. The AMT included as an adjustment the difference between accelerated depreciation claimed under the regular tax system and depreciation calculated under the AMT's less generous allowance schedules. As described in Part II.A. of this document, other AMT preferences and adjustments deferred the recovery of other capital costs that are deductible under the regular tax. Thus, the greater a corporation's capital assets, the greater its total value of accelerated depreciation and other capital-related preferences and adjustments, and the greater the likelihood the corporation would have been an AMT taxpayer. For the same reason, a capital-intensive business was more likely to be subject to the AMT than would a less capital-intensive business with equal gross revenues. The U.S. General Accounting Office ("GAO") estimated that in 1992 25 percent of all corporate assets

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[68] See H. Rept. 99-426, pp. 305-306, and S. Rept. 99-313, p. 518.

were owned by corporations subject to the AMT.[69] In 1993, both the manufacturing and the transportation and public utility industries had more than half of industry assets in corporations that were subject to the AMT.[70]

The prior-law corporate AMT was paid by relatively few corporations. For example, in 1990, approximately 32,000 of 2.1 million corporate income tax returns included an AMT liability. However, even those corporations that did not make AMT tax payments may have had their overall tax liability increase as result of increasing the corporation's tax liability by limiting the amount of credits the firm could claim against its regular income tax. The AMT liability forms a floor (the tentative minimum tax) that may limit the amount of credits the firm could claim against its regular taxes. Table 10 reports corporate AMT taxpayers and those other corporations limited by the tentative minimum tax as a percentage of all corporate income tax returns between 1987 and 1993.

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[69] General Accounting Office, *Experience With the Corporate Alternative Minimum Tax*, (GAO/GGD-95-88), April 1995, p. 36.

[70] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, D.C.: The Brookings Institution), 1997, p. 115.

Table 10.--Corporate AMT Taxpayers as a Percentage of All Corporate Returns, 1987-1993

Year	Percentage of AMT taxpayers	Percentage of regular tax taxpayers constrained by tentative minimum tax	Total
1987	0.98	0.66	1.64
1988	1.10	0.55	1.65
1989	1.15	0.57	1.72
1990	1.52	0.54	2.06
1991	1.46	0.41	1.87
1992	1.35	0.61	1.96
1993	1.43	0.66	2.09

Source: Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, D.C.: The Brookings Institution), 1997, Table 6-3.

In 1992, total corporate income tax revenue was $96.8 billion. Of this amount, AMT payments contributed $4.9 billion, and $2.3 billion in credits for prior AMT paid were claimed. The net, $2.6 billion, comprised 2.6 percent of all corporate income tax payments.

As noted above, the 1993 Act eliminated the ACE depreciation adjustment for property placed in service after 1993 and the 1997 Act allowed the use of regular tax ACRS lives in computing depreciation for property placed in service after 1998. Over time, these changes should reduce the number of corporate AMT taxpayers and the AMT liabilities relative to the data reported here for 1992 and earlier. These changes also should make it less likely that, all else equal, capital intensive businesses are subject to the AMT.

Recognizing the importance of the treatment of depreciation and other capital costs under the AMT may also explain the apparent counter-cyclic pattern of Table 3 (second column), where the percentage of corporate AMT taxpayers increased as the economy experienced recession and declined with recovery. Fixed capital assets produce a schedule of depreciation deductions that is invariant to economic conditions. As the economy enters a recession, business receipts fall. Consequently, corporate income as measured under the regular tax declines, but depreciation deductions generally remain the same.[71] Because, in simple terms, a taxpayer becomes subject to the AMT when its AMT tax preferences and adjustments become large relative to its regular taxable income,[72] a recession increases the likelihood that a business will become an AMT taxpayer. However, the data for the period 1989 through 1992 may overstate the potential for a counter-cyclical relationship between the corporate AMT and macroeconomic performance. During this period the ACE adjustment replaced the book adjustment causing a substantial increase in capital cost adjustments under the ACE adjustment. Nevertheless, the recent changes in the corporate AMT would be expected to reduce any counter-cyclic effect of the AMT.

2. Discussion of issues

Overview

In general, the AMT applies a lower marginal rate of tax to a broader tax base. Thus, the AMT may simultaneously lower the taxpayer's marginal tax rate (the amount of tax liability arising from an additional, or marginal, dollar of income) while increasing the taxpayer's average rate of tax (total tax divided by total income). Strictly speaking, the corporate AMT (and to some extent the individual AMT) is not a separate tax but is a calculation that assesses a larger income tax liability today in return for a reduced income tax liability in the future. Each dollar of corporate AMT paid today generates credits that may be applied against future regular income tax liabilities. However, because AMT credits accrue in nominal dollars, the time value of

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[71] A business may reduce its purchases of capital equipment during a recession, thereby reducing deductions for depreciation over time.

[72] A taxpayer pays the AMT if its AMT tax liability exceeds its regular tax liability. Let Y represent a corporation's regular taxable income. Let P represent AMT preferences. Then alternative minimum taxable income is (Y+P), and ignoring graduated marginal tax rates under the regular tax, a taxpayer is subject to the AMT when:

$$(.20)(Y+P) > (.35)Y.$$

Simplifying, this is equivalent to:

$$(.20)\,P > (.15)Y$$

$$\text{or} \qquad P/Y > .75.$$

As preferences become large relative to income, the taxpayer is more likely to be subject to the AMT.

money erodes the future value of such credits. As a consequence, the AMT increases the real tax liability of AMT taxpayers.

As a pre-payment of tax rather than a separate tax, the AMT should be assessed as part of the individual and corporate income taxes. Analysts usually evaluate taxes in terms of: (1) equity--the fairness of the tax; (2) efficiency--the extent to which the tax distorts economic decisions; (3) growth--the extent to which the tax system encourages or discourages economic growth; and (4) simplicity--the ease of compliance and administration by affected taxpayers and the IRS.

Equity

In practice, the AMT has the effect of requiring more taxpayers to pay over some funds to the Federal Treasury every year, than would be the case if only the regular income taxes applied. To the extent that taxpayers who outwardly appear to have the ability to pay taxes indeed do pay taxes, some observers conclude that the AMT increases the perceived fairness of the income tax system. The Senate Finance Committee noted that this was one of the rationales for the enactment of the corporate AMT.

> In particular, both the perception and the reality of fairness have been harmed by instances in which major companies have no taxes in years in which they reported substantial earnings, and may even have paid substantial dividends to shareholders. Even to the extent that theses instances may reflect deferral, rather than permanent avoidance, of corporate tax liability, the committee believes that they demonstrated a need for change.[73]

To assess whether the AMT promotes the overall equity of the individual and corporate income tax systems, it is necessary to look beyond who remits tax payments to the Federal Treasury to who bears the burden of the individual and corporate income taxes. Regarding the corporate income taxes, economists argue that corporations do not bear the burden of the corporate income tax, but rather individuals bear the burden of the corporate income tax and all other taxes. There is disagreement, however, over which individuals bear the burden of corporate income tax, whether it is customers in the form of higher prices, workers in the form of reduced wages, owners of all capital in the form of lower after-tax returns on investment, or some combination of these individuals.[74] The uncertainty regarding the incidence of income

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[73] Senate Committee on Finance, *Report on H.R. 3838, the "Tax Reform Act of 1986,"* p. 519.

[74] For a discussion of incidence of the corporate income tax and taxes on the return to capital, see, Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-51.

taxes on the returns to capital make it difficult to assess the effect the corporate AMT has on the equity of the burden of the income tax system. As noted above, the AMT raises effective average tax rates for affected taxpayers.

Some analysts argue that the AMT promotes horizontal equity by taxing more equally taxpayers who have the same economic capacity but choose to engage in different patterns of tax-favored activities. Other analysts note that in a market economy, investment by individuals and corporations would be expected to equilibrate risk-adjusted, after-tax returns. As a consequence, the prices of tax-favored investments would be bid up (or their quantity increase) and the prices of tax-disfavored investments would fall (or their quantity decrease). In equilibrium, the pre-tax returns of tax-favored and tax-disfavored investments would differ, but their after-tax returns would be the same.[75] For example, tax-exempt bonds trade at interest rates lower than otherwise comparable taxable bonds. This is because the tax-exempt borrower does not have to offer as great an interest rate to the lender to provide the lender with a competitive after-tax return. If after-tax returns equilibrate, analysts may questions whether a horizontal inequity existed prior to the enactment of the AMT.

Other analysts note that because, as explained above, the business cycle may move taxpayers onto and off the AMT that the AMT may create its own horizontal inequities by taxing different businesses differently based on the variability of their profits during the course of a business cycle.[76]

Efficiency and growth

A tax system is efficient if it does not distort the choices that would be made in the absence of the tax system. No tax system can be fully efficient. Whether the AMT contributes to the efficiency of the United States tax system depends on the extent to which it reduces other inefficiencies in the tax system and the extent to which it creates new inefficiencies. By discouraging some individuals and corporations from undertaking what are otherwise tax-favored investments, efficiency may be increased. However, the AMT generally does not eliminate tax-favored treatment of certain activities or investments, but rather limits which taxpayers may take full advantage of the tax-favored treatment provided by the regular income tax. Some analysts have noted that on efficiency grounds, "no one should care if ten companies each invest a little in

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[75] Andrew B. Lyon, "The Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research), 1991, pp. 51-82.

[76] Charles R. Hulten, "Commentary," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research), 1991, pp. 84-88.

a tax-preferred activity or one company invests a lot" in such an activity.[77] However, under present law, the ten firms described above could each avoid the AMT while the one firm with the aggregated investment could be subject to the AMT. In addition, limiting which corporations can profitably undertake tax-favored activities could lead to more efficient investors finding the activity unprofitable, while less efficient investors find the activity profitable. Moreover, some tax-favored activities may be permitted as part of the regular income tax as a way reduce some other inefficiency in the economy. These arguments might suggest that efficiency could be better improved by changes in the regular income taxes.

In the mid-1980s there was concern that the regular income tax system created different effective tax rates on capital investment depending upon the source of finance and type of equipment being purchased by the investor. It has been argued that such differentials in effective tax rates reduce the efficiency of investment in the United States. For example, the regular income tax has been criticized as favoring debt-financed investments at the expense of equity-financed investments. Subsequent to the Tax Reform Act of 1986, analysts debated whether the AMT made taxation of income from investment, more neutral and more efficient, or less neutral and less efficient.[78] The efficiency of investment under the reduced scope of the present-law corporate AMT remains an open question.

The AMT may affect the level of investment in the United States and thereby affect economic growth. Under prior law, there was some evidence that firms temporarily on the AMT experienced a greater variance in effective tax rates than did other firms.[79] This variance and uncertainty regarding taxation could have inhibited investment. The reduced scope of present-law corporate AMT may promote more certainty for taxpayers regarding the tax burden their investments are likely to bear and lead to increased aggregate investment. The AMT also may affect aggregate investment by other means. By increasing average tax rates (the total tax paid by certain taxpayers), the AMT may reduce the cash flow of potential investors. If as some analysts believe, investors' cash flows are important to the investment decision, the AMT may reduce aggregate investment.

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[77] Michael J. Graetz and Emil M. Sunley, "Minimum Taxes and Comprehensive Tax Reform," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.) *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: The Brookings Institution), 1988, p. 406.

[78] For example, see B. Douglas Bernheim, "Incentive Effects of the Corporate Alternative Minimum Tax," in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, 3, (Cambridge: The MIT Press), 1989 and Andrew B. Lyon, "Investment Incentives under the Alternative Minimum Tax," *National Tax Journal*, 43, December 1990, pp. 451-465.

[79] Lyon, *"Investment Incentives under the Alternative Minimum Tax."*

Simplicity and compliance

The AMT requires a calculation of a second income tax base[80] and computation of a tax on that base, so the present tax system, with an AMT, is not as simple to administer or comply with as would the same system without an AMT. As detailed above, relatively few corporate taxpayers are subject to the AMT. However, that observation understates the extent to which the AMT imposes a compliance burden on taxpayers. Many taxpayers must undertake the AMT calculation to determine whether, in fact, they are liable. For example, the GAO reported that while only 28,000 corporations actually paid corporate AMT in 1992, 400,000 corporations filed the AMT form.[81] The 400,000 figure would understate the number of corporations that did the necessary calculations to determine whether they had an AMT liability.

Survey evidence has suggested that the compliance cost to taxpayers required by the AMT may be large. One analysis of tax compliance costs of large businesses finds that being subject to the AMT adds 16.9 percent to the personnel and nonpersonnel compliance costs of complying with Federal income taxes.[82] The average total income tax compliance cost reported in the survey was approximately $1 million, implying that complying with the corporate AMT may require additional expenditures of $160,000 annually by large businesses. While a large number, compliance costs generally are larger for larger businesses which often have more complex business arrangements. The AMT is not the mostly costly aspect of tax compliance. The same study identifies approximately 40 percent of total compliance costs as arising from foreign-source income and that having an ongoing appeal or tax litigation increases compliance costs by 18 to 28 percent.

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[80] The ACE adjustment causes corporations to have three tax bases.

[81] GAO, *Experience With the Corporate Alternative Minimum Tax*, p. 3.

[82] Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," *Public Finance Quarterly*, 24 (October 1996), pp. 411-438.

PART FOUR: EXPIRED AND EXPIRING FEDERAL TAX PROVISIONS, 1998-2008

A. Provisions That Expired in 1998

	Provision (Code section)	Expiration Date
1.	Nonconventional fuels tax credit for fuel from biomass and coal – facilities placed in service pursuant to binding contracts before January 1, 1997 (sec. 29)	6/30/98
2.	Moratorium on regulations regarding employment taxes of limited partners (sec. 1402(a)(13) and sec. 935 of the Taxpayer Relief Act of 1997 (the "1997 Act"))	6/30/98
3.	Temporary increase in limit on cover over of rum excise tax revenues (from $10.50 to $11.30 per proof gallon) to Puerto Rico and the Virgin Islands (sec. 7652(f))	9/30/98
4.	Personal tax credits fully allowed against regular tax liability without regard to the alternative minimum tax (sec. 26)	12/31/98
5.	Special rules for qualified mortgage bond-financial loans in Presidentially declared disaster areas (sec. 143(k)(11))	12/31/98

B. Provisions Expiring in 1999

	Provision (Code section)	Expiration Date
1.	Tax credit for research and experimentation expenses (sec. 41)	6/30/99
2.	Work opportunity tax credit (sec. 51)	6/30/99
3.	Welfare-to-work tax credit (sec. 51A)	6/30/99
4.	Tax credit for electricity production from wind and closed-loop biomass--facilities placed in service date (sec. 45(c))	6/30/99
5.	Waiver of penalty for failure of small business to use Electronic Funds Transfer Payment System ("EFTPS")	6/30/99[83]
6.	Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells (sec. 613A)	12/31/99
7.	Qualified zone academy bonds (sec. 1397E)	12/31/99
8.	Exceptions under subpart F for active financing income (secs. 953 and 954)	12/31/99

[83] The Internal Revenue Service has administratively extended the waiver through June 30, 1999. IRS Notice 98-68, November 18, 1998. The previous statutory waiver expired June 30, 1998; see section 931 of the 1997 Act.

C. Provisions Expiring in 2000

	Provision (Code section)	Expiration Date
1.	Exclusion for employer-provided educational assistance (sec. 127)	5/31/00
2.	Enhanced deduction for corporate contributions of computer equipment to elementary and secondary schools (sec. 170(e)(6))	12/31/00
3.	Expensing of "Brownfields" environmental remediation costs (sec. 198)	12/31/00
4.	Establishment of Medical Savings Accounts ("MSAs") (sec. 220)	12/31/00[84]
5.	Tax credit for first-time D.C. home buyers (sec. 1400C)	12/31/00
6.	Transfers of excess pension assets to retiree health accounts (sec. 420)	12/31/00

[84] The ability of individuals to establish MSAs may expire earlier than December 31, 2000, if certain numerical limits on the number of MSAs established are exceeded.

D. Provisions Expiring in 2001

	Provision (Code section)	Expiration Date
1.	Tax on failure to comply with mental health parity requirements applicable to group health plans (sec. 9812)	9/29/01
2.	Tax credit for non-special needs adoption (sec. 23(d)(2)(B))	12/31/01
3.	Exclusion for employer-provided adoption assistance (sec. 137(f))	12/31/01

E. Provisions Expiring in 2002

	Provision (Code section)	Expiration Date
1.	Combined employment tax reporting demonstration project (sec. 976 of the 1997 Act)	8/5/02
2.	Tax incentives for investment in the District of Columbia:	
	a. Designation of D.C. Enterprise Zone; employment tax credit; additional expensing (sec. 1400)	12/31/02
	b. Tax-exempt D.C. economic development bonds (sec. 1400A)	12/31/02
	c. Zero percent capital gains rate for investment in D.C. for property acquired by 12/31/02; for gains through 12/31/07 (sec. 1400B)	12/31/02
3.	Luxury excise tax on passenger highway automobiles (sec. 4001)	12/31/02[85]

[85] The luxury excise tax on automobiles phases down as follows: 6 percent in 1999, 5 percent in 2000, 4 percent in 2001, and 3 percent in 2002.

F. Provisions Expiring in 2003

	Provision (Code section)	Expiration Date
1.	Disclosure of tax return information for administration of certain veterans programs (sec. 6103(l)(7)(D)(viii))	9/30/03
2.	Disclosure of tax return information to carry out administration of income contingent repayment of student loans (sec. 6103(l)(13))	9/30/03
3.	IRS user fees for letter rulings, determination letters, advance pricing agreements, and similar requests (sec. 10511 of the Revenue Act of 1987, as last amended by sec. 2 of P.L. 104-117)	9/30/03
4.	Indian employment tax credit (sec. 45A)	12/31/03
5.	Accelerated depreciation for business property on an Indian reservation (sec. 168(j))	12/31/03
6.	Joint Committee on Taxation annual report and annual joint hearings on IRS strategic plans (secs. 4001 and 4002 of the Internal Revenue Service Restructuring and Reform Act of 1998)	12/31/03

G. Provisions Expiring in 2004

	Provision (Code section)	Expiration Date
1.	Empowerment zone tax incentives (employment tax credit, additional expensing, tax-exempt bonds) generally (secs. 1391, 1394, and 1396)	12/31/04[86]
2.	Tax credit for qualified electric vehicles (sec. 30)	12/31/04[87]
3.	Deduction for clean-fuel vehicles and refueling property (sec. 179A)	12/31/04[88]

[86] This expiration date does not apply to new empowerment zones added by the 1997 Act, which expire later. See, I. Provisions Expiring in 2007 and J. Provisions Expiring in 2008, below.

[87] The credit phases down for vehicles placed in service after December 31, 2001. The credit is reduced by 25 percent in 2002, 50 percent in 2003, and 75 percent in 2004. No credit is available after 2004.

[88] The deduction phases down for vehicles placed in service after December 31, 2001. The deduction is reduced by 25 percent in 2002, 50 percent in 2003, and 75 percent in 2004. No deduction is allowed after 2004.

H. Provisions Expiring in 2005

Provision (Code section)		Expiration Date
1.	Leaking Underground Storage Tank Trust Fund excise tax (sec. 4081(d)(3))	3/31/05
2.	Highway Trust Fund excise tax rates:	
	a. All but 4.3 cents per gallon of the taxes on highway gasoline, diesel fuel, kerosene, and special motor fuels (secs. 4041(a) and 4081(d)(1))[89]	9/30/05
	b. Tax on retail sale of heavy highway vehicles (sec. 4051(c))	9/30/05
	c. Tax on heavy truck tires (sec. 4071(d))	9/30/05
	d. Annual use tax on heavy highway vehicles (sec. 4481)	9/30/05
3.	Aquatic Resources Trust Fund and Land and Water Conservation Fund excise tax on motorboat gasoline and special fuels (secs. 4041(a) and 4081(a)(1))--all but 4.3 cents per gallon[90]	9/30/05
4.	Puerto Rico economic activity tax credit (sec. 30A)	12/31/05
5.	Puerto Rico and possessions tax credit (sec. 936)	12/31/05

[89] The 4.3-cents-per-gallon rate is permanent.

[90] The 4.3-cents-per-gallon rate is permanent.

I. Provisions Expiring in 2007[91]

	Provision (Code section)	Expiration Date
1.	Airport and Airway Trust Fund excise taxes:	
	a. All but 4.3 cents per gallon of taxes on noncommercial aviation jet fuel and noncommercial aviation gasoline (secs. 4041(c), 4081(d), and 4091)[92]	9/30/07
	b. Domestic and international air passenger ticket taxes (sec. 4261)	9/30/07
	c. Air cargo tax (sec. 4271)	9/30/07
2.	Reduced excise tax rates for alcohol fuels and alcohol fuels mixtures (secs. 4041(b)(2) and (k), 4081(c), and 4091(c))	9/30/07[93]
3.	Alcohol fuels income tax credits (sec. 40)	12/31/07[94]
4.	FUTA surtax of 0.2 percent (sec. 1301)	12/31/07
5.	Empowerment zone employment tax credit, for zones added by the 1997 Act (sec. 1396)	12/31/07 [95]

[91] There are no Federal tax provisions expiring in calendar year 2006.

[92] The 4.3-cents-per-gallon rate is permanent.

[93] The reduced rates expire earlier if the tax rate on gasoline and other motor fuels drops to 4.3 cents per gallon, which is currently scheduled to occur after September 30, 2005, unless the Highway Trust Fund tax rates are extended beyond that date.

[94] The income tax credits expire earlier if the tax rate on gasoline and other motor fuels drops to 4.3 cents per gallon, which is currently scheduled to occur after September 30, 2005, unless the Highway Trust Fund tax rates are extended beyond that date.

[95] The empowerment zone employment tax credit is only available to the two additional urban empowerment zones that were designated by February 1, 1998.

J. Provisions Expiring in 2008

	Provision (Code section)	Expiration Date
1.	Empowerment zone expensing and tax-exempt bonds, for zones added by the 1997 Act (secs. 1391 and 1394)	December 31, 2008 [96]

[96] Empowerment zone tax incentives generally expire 10 years after zone designation; thus, the empowerment zones whose designations took effect in 1998 expire December 31, 2008.