PRESENT LAW
AND BACKGROUND INFORMATION
ON CERTAIN
EXPIRING TAX PROVISIONS

Scheduled for a Hearing
by the
SUBCOMMITTEE ON TAXATION and IRS OVERSIGHT
of the
SENATE COMMITTEE ON FINANCE
on June 30, 2005

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Taxation and IRS Oversight Subcommittee of the Senate Committee on Finance has scheduled a hearing for June 30, 2005, on certain expiring tax provisions. Specifically, the hearing will address the following provisions of present law.

- The 15-percent/five-percent (zero-percent after 2007) tax rate structure applicable to income from capital gains (section 1(h)).[1] Under present law, for taxable years after 2008, the maximum rate of tax on adjusted net capital gain of an individual is 20 percent.
- The 15-percent/five-percent (zero-percent after 2007) tax rate structure applicable to qualified dividend income (section 1(h)). Under present law, for taxable years beginning after 2008, dividends received by an individual are taxed as ordinary income at rates up to 35 percent.
- The expensing of up to $100,000 of depreciable tangible personal property purchased by qualified taxpayers for use in a trade or business (section 179). Under present law, for taxable years beginning after 2007, a qualifying taxpayer may deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year.
- The above-the-line deduction for higher education expenses (section 222). Under present law, no deduction is permitted for expenses incurred after 2005.
- The credit for elective deferrals and IRA contributions (section 25B). Under present law, for taxable years beginning after 2006, no credit may be claimed for elective deferrals or IRA contributions.

This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and presents background data on the utilization of these provisions of the Code. In addition, this document briefly discusses considerations important to estimating the revenue effects of any proposed extension of these expiring provisions. To make the discussion of the estimation of the revenue effects more concrete, the staff of the Joint Committee on Taxation considers two sets of proposals. The first set of proposals would extend present law for each provision through calendar year 2010. The second set of proposals would extend present law for each provision permanently.

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[1] All references to the "Code" are to the Internal Revenue Code. All section references and descriptions of present law refer to the Code unless otherwise indicated.

[2] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Information on Certain Expiring Tax Provisions* (JCX-50-05), June 27, 2005.

I. CERTAIN EXPIRING TAX PROVISIONS

A. Tax Rates on Capital Gains and Dividends of Individuals (sec. 1(h) of the Code)

Present Law

Capital Gains

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

Tax rates before 2009

Under present law, for taxable years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual[3] is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a five-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.

[3] The tax rates applicable to individuals also apply to estates and trusts.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock),[4] the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

Tax rates after 2008

For taxable years beginning after December 31, 2008, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate is taxed at an eight-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2009.

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[4] This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent.

Dividends

In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax rates before 2009

Under present law, dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2009, dividends received by an individual are taxed at rates of five (zero for taxable years beginning after 2007) and 15 percent.[5]

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)),[6] dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Qualified dividend income includes otherwise qualified dividends received from qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program.[7] In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

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[5] Payments in lieu of dividends are not eligible for the lower rates.

[6] In the case of preferred stock, the period is 90 days within a 181-period beginning 90 days before the ex-dividend date.

[7] Treasury Notice 2003-69 (I.R.B. 2003-42, Oct. 20, 2003) provides a list of treaties satisfying this requirement.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the company is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (i) the qualified dividend income of the RIC for the taxable year and (ii) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of (i) the qualified dividend income of the REIT for the taxable year, (ii) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (iii) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.

Amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates.

Also, the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent.

Tax rates after 2008

For taxable years beginning after 2008, dividends received by an individual are taxed as ordinary income at rates up to 35 percent.

Background

Capital gains

Table 1, below, shows the number of returns estimated to have capital gains taxed at the rates of five percent and 15 percent, and amount of gains taxed at these rates, by expanded income class at 2005 levels.

Table 1. –Distribution of Capital Gains
Calendar Year 2005

Income Category[1]	Number of Returns[2]	Amount of Capital Gains in Dollars
	Millions	Billions
Less than $10,000	[3]	[4]
10,000 to 20,000.....	0.2	0.2
20,000 to 30,000.....	0.4	0.6
30,000 to 40,000.....	0.8	1.4
40,000 to 50,000.....	0.9	2.1
50,000 to 75,000.....	2.4	6.7
75,000 to 100,000.....	2.1	9.2
100,000 to 200,000.....	3.5	31.7
200,000 and over.....	1.5	275.3
Total, All Taxpayers	11.7	327.3

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad. Categories are measured at 2005 levels.

[2] Includes filing and nonfiling units. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded.

[3] Less than 50,000 returns.

[4] Less than $50 million.

Note: Details may not add to total due to rounding.
Source: Joint Committee on Taxation.

Dividends

Table 2, below, shows the number of returns expected to have qualified dividends and the dollar amount of these qualified dividends, by expanded income class at 2005 levels.

Table 2.–Distribution of Qualified Dividends
Calendar Year 2005

Income Category[1]	Number of Returns[2]	Amount of Qualified Dividends in Dollars
	Millions	Billions
Less than $10,000	0.8	2.1
10,000 to 20,000.....	0.6	1.1
20,000 to 30,000.....	1.1	2.0
30,000 to 40,000.....	1.3	2.9
40,000 to 50,000.....	1.6	3.3
50,000 to 75,000.....	3.9	9.2
75,000 to 100,000.....	3.7	8.5
100,000 to 200,000.....	6.4	18.9
200,000 and over.....	2.6	43.5
Total, All Taxpayers	22.1	91.5

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad. Categories are measured at 2005 levels.

[2] Includes filing and nonfiling units. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded.

Note: Details may not add to total due to rounding.
Source: Joint Committee on Taxation.

Revenue Estimate

Capital gains

The first proposal extends the zero- and 15-percent rates for adjusted net capital gain to taxable years beginning in 2009 and 2010. The second proposal extends the zero- and 15-percent rates for adjusted net capital gain permanently. Table 3, below, includes the estimated effects on fiscal year budget receipts of each of these proposals:

Table 3.–Fiscal Years 2006 - 2015
[Millions of Dollars]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
Two-year extension effective for taxable years beginning after December 31, 2008	—	—	-1,549	-8,375	2,672	-54	-12,698	[1]	[1]	—	-7,252	-20,004
Permanent extension effective for taxable years beginning after December 31, 2008	—	—	-1,549	-8,375	984	-8,663	-8,596	-8,857	-9,129	-9,432	-8,940	-53,617

[1] Revenue loss less than $500,000.

Note: Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

These estimates are derived from the Joint Committee's individual income tax simulation model, which is based on a sample of approximately 192,000 actual returns statistically sampled to reflect the United States' tax filing population for tax year 2001. The tax return data are aged to reflect the Joint Committee's baseline projections for the period 2005 to 2015. The Joint Committee staff's model of the taxation of capital gains assumes that the timing and amount of capital gains realized by taxpayers are affected by the rate of taxation applied to income from capital gains.

The present-law baseline for capital gains anticipates a significant shift in capital gain realizations from tax year 2009 to tax year 2008 as a result of the maximum tax rate for long-term capital gains increasing from 15 percent to 20 percent in 2009. Under both proposals, this anticipated shift in realizations from 2009 to 2008 will not occur, and capital gains realizations

will be lower in tax year 2008 and higher in tax year 2009 than is anticipated under present law. The effect on Federal fiscal year budget receipts of the lower marginal tax rate on capital gains in 2009 and the reversal of the shift in capital gains realizations from 2009 to 2008 is that receipts will be lower in fiscal years 2008 and 2009, and higher in fiscal year 2010.

Under the first proposal, the maximum tax rate on long-term capital gains will increase from 15 percent to 20 percent in tax year 2011. This will result in a shift in capital gains realizations from tax year 2011 to tax year 2010. The effect on Federal fiscal year budget receipts of the lower capital gains tax rate in tax year 2010 and the shift in capital gains realizations from 2011 to 2010 is that receipts will be virtually unchanged in fiscal year 2011 and will be lower in fiscal year 2012. Under the permanent extension, taxpayers have no incentive to alter the timing of realizations between 2010 and 2011. The estimate of the permanent extension reflects a smoother path of future realizations.

Dividends of Individuals

The first proposal extends the zero- and 15-percent rates on dividends of individuals to taxable years beginning in 2009 and 2010. The second proposal extends the zero- and 15-percent rates on dividends of individuals permanently. Table 4, below, includes the estimated effects on fiscal year budget receipts of each of these proposals:

Table 4.–Fiscal Years 2006 - 2015
[Millions of Dollars]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-2010	2006-2015
Two-year extension effective for taxable years beginning after December 31, 2008	—	—	-860	-4,431	-8,008	-9,368	-6,326	-1,224	-450	-112	-13,299	-30,779
Permanent extension effective for taxable years beginning after December 31, 2008	—	—	-853	-4,358	-8,703	-14,197	-17,662	-19,542	-20,913	-22,321	-13,914	-105,548

Note: Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

These estimates also are derived from the Joint Committee's individual income tax simulation model, which is based on a sample of approximately 192,000 actual returns statistically sampled to the reflect the United States' tax filing population for tax year 2001. The tax return data are aged to reflect the Joint Committee's baseline projections for the period 2005 to 2015.[8] Because of interactions with capital gains, the special rates on dividends were applied after the special rates on capital gains had been estimated.

The Joint Committee's baseline estimate of dividend levels assumes that there will be a significant shift of dividends from tax year 2009 into tax year 2008 (i.e., some corporations will accelerate their dividend payments and make distributions in 2008 not 2009). By extending the special rates to 2010, the shifting of dividends into 2008 will not occur, but there will be significant shifting of dividends from tax year 2011 to tax year 2010. That is, some corporations will accelerate their dividend payments and make distributions in 2010 not 2011. This is reflected in the decline in receipts in fiscal year 2008 and fiscal year 2012.

The Joint Committee staff's baseline estimates also assume corporations will have higher dividend payouts in years when the special rates on dividends are in effect. By extending the rates, the JCT staff assumes that corporations will continue with their higher dividend payouts. Further, corporations will have higher dividend payouts under a permanent extension relative to an extension which sunsets in 2010. The estimates assume that the additional dividend payouts will be offset by fewer capital gains realizations in future years. The increase in dividend payouts results in higher liabilities in the year of the payout. The reduced capital gains will be spread out over several years. This largely explains why there are revenue losses for fiscal years 2013 to 2015 under the proposal where the special rates sunset in 2010.

[8] The revenue estimate includes the effects on liabilities from fiduciaries.

B. Expensing in Lieu of Depreciation for Small Business (sec. 179 of the Code)

Present Law

In general

Under present law, in lieu of depreciation, a taxpayer may elect to treat as an expense the cost of certain qualifying property placed in service during a taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

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

Taxable years beginning before 2008

For taxable years beginning after December 31, 2002 and before January 1, 2008, the cost of qualifying property placed in service for the taxable year that may be expensed is $100,000. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

With respect to a taxable year beginning after December 31, 2002 and before January 1, 2008, taxpayers are permitted to revoke expensing elections on amended returns without the consent of the Commissioner.[9] For such taxable years, qualifying property includes certain computer software.

Taxable years beginning after 2007

For taxable years beginning after December 31, 2007,[10] the cost of qualifying property that may be expensed is $25,000. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

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[9] Under Prop. and Temp. Treas. Reg. sec. 1.179-5T, applicable to property placed in service in taxable years beginning after 2002 and before 2006, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9146, Aug. 3, 2004.

[10] These limits also applied to taxable years beginning before January 1, 2003.

For taxable years beginning after December 31, 2007, qualifying property does not include certain computer software. An expensing election may be revoked only with consent of the Commissioner.[11]

Background

The Joint Committee staff estimates approximately 400,000 business taxpayers (sole proprietors, partnerships, S corporations, and C corporations) will claim additional expensing under the higher eligible amounts of section 179 in 2005, compared to the law prior to 2003.

Revenue Estimate

The first proposal extends for three years (through taxable years beginning in 2010) the provision permitting up $100,000 of depreciable property to be expensed. The second proposal extends this provision permanently. Table 5, below, includes the estimated effects on fiscal year budget receipts of each of these proposals:

Table 5.–Fiscal Years 2006 - 2015
[Millions of Dollars]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
Three-year extension effective for taxable years beginning after December 31, 2007	—	—	-2,605	-4,459	-3,358	702	3,671	2,446	1,650	1,070	-10,423	-884
Permanent extension effective for taxable years beginning after December 31, 2007	—	—	-2,605	-4,459	-3,221	-2,449	-1,953	-1,609	-1,431	-1,385	-10,286	-19,113

Note: Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

[11] Sec. 179(c)(2).

The Joint Committee staff's estimates of these proposals are based on the examination of tax returns of sole proprietors, partnerships, S corporations, and C corporations. These returns contain data on depreciation and other expenditures claimed by such businesses.

Section 179 has the effect of allowing taxpayers to deduct costs of certain business or investment property in the year the property is placed in service, rather than through annual depreciation deductions over a longer period. The first proposal that extends by three years the period for which increased section 179 amounts are available therefore provides a speed-up in deductions for qualified property placed in service in taxable years 2008 through 2010. The second proposal provides a permanent extension and there is a speed-up in deductions for qualified property placed in service in all years after 2007.

For a specific investment, section 179 generates a reduction in tax revenues in the investment year followed by an approximately equal increase in revenues over the following years in which depreciation deductions would otherwise apply. Therefore, for any specific investment, the cumulative revenue effect over a number of years (setting aside changes in tax rates or other taxpayer characteristics) nets out to zero. For the first proposal, this pattern, aggregated across all qualified investment in years 2008 through 2010, is the basis for the overall pattern of revenue losses in fiscal years 2008 through 2010 followed by offsetting revenue increases through 2015 and beyond. For the permanent extension, the revenue losses diminish in each of the years shown in Table 5 as the offsetting effect of expensed amounts from earlier years builds up but does not outweigh the effect of the speedup in deductions for new qualified investments.

The estimates assume that there is a modest amount of shifting of investment between activities and years in response to the section 179 investment incentive.

C. Above-the-Line Deduction for Higher Education Expenses (sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[12] Qualified tuition and related expenses include tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the deduction. 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.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,[13] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain United States Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[14] Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for exclusion under section 222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

For taxable years beginning in 2004 and 2005, the maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to

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[12] Sec. 222.

[13] Sec. 222(d)(1) and sec. 25A(g)(2).

[14] Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2005.

Background

Table 6, below, shows the number of returns expected to take a deduction for qualified tuition and related expenses and the dollar amount of the deduction, by expanded income class at 2005 levels.

Table 6.–Distribution of Tuition Deduction
Calendar Year 2005

Income Category[1]	Number of Returns[2]	Amount of Tuition Deduction in Dollars
	Millions	Billions
Less than $10,000	[3]	[4]
10,000 to 20,000.....	[3]	[4]
20,000 to 30,000.....	[3]	[4]
30,000 to 40,000.....	[3]	0.1
40,000 to 50,000.....	0.1	0.1
50,000 to 75,000.....	0.5	1.1
75,000 to 100,000.....	0.3	0.5
100,000 to 200,000.....	1.8	3.3
200,000 and over.....	[3]	[4]
Total, All Taxpayers	2.8	5.2

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad. Categories are measured at 2005 levels.

[2] Includes filing and nonfiling units. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded.

[3] Less than 50,000 tax returns.

[4] Less than $50 million.

Note: Detail may not add to total due to rounding.
Source: Joint Committee on Taxation.

Revenue Effect

The first proposal extends the deduction for qualified tuition and related expenses to taxable years beginning after 2005 and before 2011. The second proposal extends the deduction for qualified tuition and related expenses permanently. Table 7, below, includes the estimated effects on fiscal year budget receipts of each of these proposals:

Table 7.–Fiscal Years 2006 - 2015
[Millions of Dollars]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
Five-year extension effective for payments made in taxable years beginning after December 31, 2005	-420	-1,713	-1,835	-1,922	-2,023	-1,557	—	—	—	—	-7,913	-9,470
Permanent extension effective for payments made in taxable years beginning after December 31, 2005	-420	-1,713	-1,835	-1,922	-2,023	-1,989	-1,743	-1,786	-1,803	-1,830	-7,913	-17,062

Note: Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

These estimates are derived from the Joint Committee's individual income tax simulation model, which is based on a sample of approximately 192,000 actual returns statistically sampled to reflect the United States' tax filing population for tax year 2001. The tax return data are aged to reflect the Joint Committee's baseline projections for the period 2005 to 2015.

The revenue estimates reflect the Joint Committee staff's view that any behavioral response to the expiring of the deduction, such as accelerating qualified expenses into the year prior to expiration, is small because taxpayers' ability to shift qualified educational expenses forward to get the deduction may be limited and the maximum deduction for qualified tuition and related expenses is $2,000 or $4,000 per year. The first proposal would provide for a deduction for expenses incurred through 2010. Many such deductions for 2010 would be

claimed on the taxpayer's 2010 return, which is filed in fiscal year 2011. Hence the Joint Committee staff's estimate projects revenue losses for fiscal year 2011.

Under the permanent extension of the above-the-line deduction for higher educational expenses, the size of the annual revenue loss declines significantly in years immediately after FY 2010. This decline is the result of interactions between the deduction, the HOPE and Lifetime Learning tax credits (the "education tax credits"), and the alternative minimum tax ("AMT"). The effects of the interactions are more pronounced after the expiration of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), which expires at the end of 2010.

With respect to a given student, taxpayers eligible for either the deduction or one of the education tax credits must choose only one of the benefits. The Joint Committee's individual income tax simulation model assumes taxpayers will opt for the alternative that minimizes their income tax liability. Because the education tax credits are not allowed against the alternative minimum tax in years after 2005, taxpayers subject to the AMT, but eligible for either a tax credit or the deduction, would be more likely to take the deduction. The expiration of EGTRRA in 2010 results in an increase in individual income tax rates to their pre-EGTRRA levels, which results in a significant decline in taxpayers being subject to the AMT, and relatively more taxpayers opting for the education tax credits instead of the deduction.

D. Credit for Elective Deferrals and IRA Contributions (the "Saver's Credit") (sec. 25B of the Code)

Present Law

For taxable years beginning before January 1, 2007, eligible taxpayers may claim a nonrefundable credit for qualified retirement savings contributions.[15] The maximum annual contribution eligible for the Saver's Credit is $2,000. The maximum credit rate is 50 percent, resulting in a maximum credit of $1,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer.[16] Joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and unmarried individual returns of $25,000 or less are eligible for the credit. For these purposes, married taxpayers filing separate returns are treated as unmarried individuals. The credit is available in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit is allowable against individual alternative minimum tax liability as well as individual regular tax liability. The Saver's Credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The Saver's Credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b)" annuity), an eligible deferred compensation arrangement of a State or local government (a "section 457 plan"), a SIMPLE,[17] or a simplified employee pension ("SEP"); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax-sheltered annuity or qualified retirement plan.

The amount of any contribution eligible for the Saver's Credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return with the spouse) from any plan or IRA to which eligible contributions can be made during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.[18]

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[15] Sec. 25B.

[16] The credit rates based on AGI are provided in Table 8, below.

[17] Certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan.

[18] Certain other types of distributions do not reduce the credit (e.g., loans treated as deemed distributions).

Table 8, below, shows the credit rates based on AGI.

Table 8.–Credit Rates Based on AGI

Joint Filers	***Credit Rate***
$0 to $30,000	50 percent
$30,001 to $32,500	20 percent
$32,501 to $50,000	10 percent
Over $50,000	0 percent
Head of Households	*Credit Rate*
$0 to $22,500	50 percent
$22,501 to $24,375	20 percent
$24,376 to $37,500	10 percent
Over $37,500	0 percent
All Other Filers	*Credit Rate*
$0 to $15,000	50 percent
$15,001 to $16,250	20 percent
$16,251 to $25,000	10 percent
Over $25,000	0 percent

Background

Table 9, below, shows the number of returns expected to receive a tax credit for qualified retirement saving contributions and the dollar amount of the contributions on which the credit is calculated, by expanded income class at 2005 levels.

Table 9.–Distribution of Elective Deferrals and IRA Contributions on which the Credit is Calculated Calendar Year 2005

Income Category[1]	Number of Returns[2]	Amount of Elective Deferrals and IRA Contributions on which the Credit is Calculated, in Dollars
	Millions	Billions
Less than $10,000	[3]	[4]
10,000 to 20,000.....	0.8	0.5
20,000 to 30,000.....	1.9	1.8
30,000 to 40,000.....	1.8	2.0
40,000 to 50,000.....	1.6	2.4
50,000 to 75,000.....	2.2	3.6
75,000 to 100,000.....	[3]	0.1
100,000 to 200,000.....	[3]	[4]
200,000 and over.....	---	---
Total, All Taxpayers	8.4	10.3

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad. Categories are measured at 2005 levels.

[2] Includes filing and nonfiling units. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded.

[3] Less than 50,000 tax returns.

[4] Less than $50 million.

Note: Detail may not add to total due to rounding.
Source: Joint Committee on Taxation.

Revenue Effect

The first proposal extends the Saver's credit to taxable years beginning after 2006 and before 2011. The second proposal extends the Saver's credit permanently. Table 10, below, includes the estimated effects on fiscal year budget receipts of each of these proposals.

Table 10.–Fiscal Years 2006 - 2015
[Millions of Dollars]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
Four-year extension effective for taxable years beginning after December 31, 2006	—	-481	-1,428	-1,318	-1,238	-808	-20	-20	-19	-20	-4,464	-5,351
Permanent extension effective for taxable years beginning after December 31, 2006	—	-481	-1,428	-1,318	-1,238	-1,210	-1,181	-1,093	-1,009	-943	-4,464	-9,901

Note: Details do not add to totals due to rounding.
Source: Joint Committee on Taxation.

These estimates are derived from the Joint Committee's individual income tax simulation model, which is based on a sample of approximately 192,000 actual returns statistically sampled to reflect the United States' tax filing population for tax year 2001. The tax return data are aged to reflect the Joint Committee's baseline projections for the period 2005 to 2015.

Taxpayers with adjusted gross income below a certain level are eligible for an income tax credit on certain elective deferrals to 401(k) plans, 403(b) annuities, 457 plans, SIMPLEs or SEPs and contributions to Individual Retirement Arrangements ("IRAs"). This tax credit may induce some taxpayers to make additional elective deferrals or IRA contributions beyond what they otherwise would make. The revenue estimates not only reflect the cost associated with the tax credit on qualified retirement saving contributions, but also include the revenue cost from the tax deduction and tax deferral on earnings associated with the additional contributions. Taxpayers benefit from the tax deferral on earnings until withdrawal; therefore, the revenue cost from tax deferral on the earnings associated with the additional contributions is present even in years after the tax credit expires.

The revenue estimates reflect the Joint Committee staff's view that any behavioral response to the expiring of the tax credit, such as accelerating qualified retirement savings contributions into the year prior to expiration, is likely to be small for numerous reasons. The tax credit is targeted to relatively low-income taxpayers who may be unaware that the tax credit is expiring or may not engage in any cross-year tax planning. In addition, even if such taxpayers were aware that the tax credit was expiring, they may be unable or reluctant to accelerate retirement contributions because of the potential small size of the tax credit (as low as 10 percent

of qualified retirement savings contributions), limited funds to make such a contribution, limited ability to borrow, or a belief that the credit will ultimately be extended. Finally, because the tax credit is limited to $2,000 in qualified retirement savings contributions per year, taxpayers already contributing the maximum amount for purposes of the credit in 2010 would not benefit from accelerating contributions planned to be made in 2011. The size of the annual revenue loss from the Saver's Credit declines over the ten-year period under both proposals. Because the AGI thresholds are not indexed for inflation, the credit is reduced or denied as more taxpayers' AGI exceeds the present-law AGI thresholds to claim the credit.

APPENDIX

Table A.1.−Distribution by Income Class of All Returns, Taxable Returns, Itemized Returns, and Tax Liability at 2004 Rates and 2004 Law and 2004 Income Levels [1]

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	All returns [3]	Taxable returns	Itemized returns	Tax Liability
Below $10,000	25,426	589	301	-$6,824
$10,000 to $20,000	22,336	6,742	896	-13,424
$20,000 to $30,000	19,811	8,688	1,899	-2,473
$30,000 to $40,000	16,580	10,390	3,287	12,214
$40,000 to $50,000	13,101	10,025	4,228	24,218
$50,000 to $75,000	22,875	20,129	10,721	76,832
$75,000 to $100,000	13,584	13,261	9,556	83,229
$100,000 to $200,000	14,383	14,260	12,506	195,823
$200,000 and over	3,454	3,430	3,281	353,082
Total	**151,449**	**87,512**	**46,675**	**$722,676**

[1] Tax law as in effect on November 1, 2004, is applied to the 2004 level and sources of income and their distribution among taxpayers.

[2] The income concept used to place tax returns into classes is adjusted gross income (AGI) plus: (a) tax-exempt interest, (b) employer contributions for 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) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

[3] Includes filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.