DESCRIPTION OF THE CHAIRMAN’S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 3997, “HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2007”

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of the "Heroes Earnings Assistance and Relief Tax Act of 2007." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's amendment in the nature of a substitute to H.R. 3997, the "Heroes Earnings Assistance and Relief Tax Act of 2007."

[1] This document may be cited as follows: Joint Committee on Taxation, *"Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 3997, the "Heroes Earnings Assistance and Relief Tax Act of 2007,"* November 1, 2007, (JCX-107-07). This document can also be found on our website at www.house.gov/jct.

I. BENEFITS FOR MILITARY AND VOLUNTEER FIREFIGHTERS

A. Make Permanent the Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit

Present Law

In general

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone may be excluded from gross income. In addition, for up to two years following service in a combat zone, military personnel may also exclude compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the combat zone.

Child credit

Combat pay that is otherwise excluded from gross income under section 112 is treated as earned income which is taken into account in computing taxable income for purposes of calculating the refundable portion of the child credit.

Earned income credit

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending before January 1, 2008.

Description of Proposal

The provision permanently extends the availability of the election to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit.

Effective Date

The provision is effective in taxable years beginning after December 31, 2007.

B. Modification of Qualified Mortgage Bond Program Rules for Veterans

Present Law

In general

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

Qualified mortgage bonds

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

Under a special rule, qualified mortgage bonds may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement. Present-law income and purchase price limitations apply to loans to veterans financed with the proceeds of qualified mortgage bonds. Veterans are eligible for the exception from the first-time homebuyer requirement without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty. However, veterans may only use the exception one time, and the exception only applies to financing provided from bonds issued before January 1, 2008.

Qualified veterans mortgage bonds

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

In the case of qualified veterans' mortgage bonds issued by California or Texas, mortgage loans only can be made to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service. In the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, mortgage loans can be made to veterans who apply for financing before the date 25 years after the last date on which such veteran left active service, without regard to the calendar year the veteran served on active duty.

The annual volume of qualified veterans' mortgage bonds that can be issued in California or Texas is based on the average amount of bonds issued in the respective State between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued in years after 2009 is $25 million. This $25 million per-State limit is phased in from 2006 through 2009 by allowing the applicable percentage of the $25 million limit. The following table provides those percentages.

Calendar Year:	Applicable Percentage is:
2006	20 percent
2007	40 percent
2008	60 percent
2009	80 percent

Unused allocation cannot be carried forward to subsequent years.

Description of Proposal

Qualified mortgage bonds

The proposal permanently extends the limited exception from the first-time homebuyer requirement for veterans under the qualified mortgage bond program.

Qualified veterans' mortgage bonds

The proposal increases the annual limit on qualified veterans' mortgage bonds that can be issued in Alaska, Oregon, and Wisconsin in years after 2009 to $100 million. For 2008 and 2009, the $100 million limit is phased in by applying the present-law applicable percentages for those years (i.e., 60 percent in 2008 and 80 percent in 2009).

With respect to qualified veterans' mortgage bonds issued in California or Texas, the proposal repeals the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977 and reduces the eligibility period to 25 years (rather than 30 years) following release from the military service.

Effective Date

The proposal applies to bonds issued after December 31, 2007.

C. Survivor and Disability Payments with Respect to Qualified Military Service

Present Law

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA")[2], which revised and restated the Federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service. The protections provided under USERRA do not apply if the veteran is not reemployed by the veteran's civilian employer.

USERRA generally provides that for a reemployed veteran, service in the uniformed services is considered service with the employer for retirement plan vesting and benefit accrual purposes. The employer that reemploys the returning veteran is liable for funding any resulting obligation. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. Under USERRA, any such payment to the plan must be made during the period beginning with the date of reemployment and whose duration is three times the reemployed veteran's period of uniform service, not to exceed five years.

The Small Business Job Protection Act of 1996[3] added section 414(u) to the Code to provide rules regarding the interaction of the USERRA protections with generally applicable rules that govern tax qualified retirement plans. For example, section 414(u) provides that if any make-up contribution is made by an employer or employee with respect to a reemployed veteran, then such contribution is not subject to the otherwise applicable plan contribution and deduction limits for the year in which the contribution is made (such as the sec. 402(g) annual limit on elective deferrals, which is generally $15,500 in 2007). Such limits are instead applied for the year to which the contribution relates had the individual continued to be employed by the employer during the period of uniformed service.

Under section 414(u), a plan to which a make-up contribution is made on account of a reemployed veteran is not treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules[4] by reason of the making of such

[2] Pub. L. No. 103-353, 38 U.S.C. §§ 4301, ff.

[3] Pub. L. No. 104-188.

[4] I.e., Code sections 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), and 416.

contribution. Consequently, for purposes of applying the requirements and tests associated with these rules, make-up contributions are not taken into account either for the year in which they are made or for the year to which they relate.

In addition, section 414(u) provides for a special rule in the case of make-up contributions of salary reduction, employer matching, and after-tax employee amounts. A plan that provides for elective deferrals or employee contributions is treated as meeting the requirements of USERRA if the employer permits reemployed veterans to make additional elective deferrals or employee contributions under the plan during the period which begins on the date of reemployment and has the same length as the lesser of (1) the period of the individual's absence due to uniformed service multiplied by three or (2) five years. The employer is required to match any additional elective deferrals or employee contributions at the same rate that would have been required had the deferrals or contributions actually been made during the period of uniformed service. Additional elective deferrals, employer matching contributions, and employee contributions are treated as make-up contributions for purposes of the rule exempting such contributions from qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules described above.

Description of Proposal

The proposal adds a new tax qualification requirement for retirement plans that are qualified under section 401(a) of the Code (a "tax-qualified plan"). Under the new requirement, a tax-qualified plan must provide that, in the case of a participant who dies while performing qualified military service, the survivors of the participant must be entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would be provided under the plan had the participant resumed employment with the employer maintaining the plan and then terminated employment on account of death. Thus, if a plan provides for accelerated vesting, ancillary life insurance benefits, or other survivor benefits that are contingent upon a participant's termination of employment on account of death, the plan must provide such benefits to the beneficiary of a participant who dies during qualified military service.

Under the proposal, conforming amendments apply the new tax qualification requirement to section 403(b) tax-deferred annuities and eligible deferred compensation plans (described in section 457(b)) maintained by state and local governments. The proposal also conditions the deduction timing rule of section 404(a)(2) (permitting contributions for the purchase of employee retirement annuities that meet certain requirements applicable to tax-qualified retirement plans to be deducted in the year of payment) on satisfaction of the new qualification requirement.

In addition, for benefit accrual purposes, the proposal permits a retirement plan to treat an individual who leaves service with the plan's sponsoring employer for qualified military service and who cannot be reemployed on account of death or disability as if the individual had been rehired as of the day before death or disability (a "deemed rehired employee") and then had terminated employment on the date of death or disability. In the case of a deemed rehired employee, the plan is permitted to comply fully or partially with the benefit accrual restoration provisions that would be required under section 414(u) had the individual actually been rehired.

Subject to several conditions, if a plan complies fully or partially with the benefit accrual requirements of section 414(u), the special section 414(u) rules regarding the interaction of USERRA with the otherwise applicable benefit limitation and nondiscrimination rules apply. The first condition is that all employees performing qualified military service of the employer maintaining the plan who die or become disabled must be credited with benefits on a reasonably equivalent basis. Thus, differences in credited benefits on account of different compensation levels are permissible, but complying fully with the section 414(u) benefit accrual requirements with respect to highly compensated employees and complying partially with respect to nonhighly compensated employees is not permissible. The second condition is that if the plan credits deemed rehired employees with benefits that are contingent on employee contributions or elective contributions, the plan must determine the rate of employee contributions or elective deferrals on the basis of the actual average contributions or deferrals made by the employee during the 12-month period prior to military service (or if less, the average for the actual period of service).

The proposal provides rules regarding the date by which a plan must be amended to comply with the proposal. In general, a plan must be amended on or before the last day of the plan year beginning on or after January 1, 2009.

Effective Date

The proposal applies in the case of deaths and disabilities occurring on or after January 1, 2007.

D. Treatment of Differential Military Pay as Wages

Present Law

In general

In the case of an employee who is called to active duty with the United States uniformed services, some employers voluntarily agree to continue paying the compensation that the service member would otherwise have received from the employer during the service member's period of active duty. Such compensation is commonly referred to as "differential pay."

Wage withholding

Differential pay is not treated as wages for purposes of the Federal income tax withholding rules that apply to an employer's payment of wages. This is because the service member terminates the employment relationship with the employer that pays the differential pay upon being called for active duty.[5]

Retirement plans

Section 415 imposes limitations on the benefits that may be provided under a retirement plan that is qualified under Code section 401(a) (a "qualified plan"). For a defined contribution plan, section 415 limits the annual additions to a participant's account under the plan to the lesser of a dollar amount ($45,000 in 2007) or 100 percent of the participant's compensation. In the case of a defined benefit plan, section 415 generally limits the annual benefit payable under the plan to the lesser of a dollar amount ($180,000 in 2007) or 100 percent of the participant's average compensation for the participant's high three years.

Final regulations issued in 2007 generally permit a plan to treat differential pay as compensation for purposes of section 415.[6] The section 415 limitations also apply to tax deferred annuities[7] and simplified employee pensions[8] ("SEPs"). The definition of compensation in section 415 is used in limiting the amount that may be deferred under an eligible deferred compensation plan (described in section 457(b)).

Limitation on in-service distributions

Under present law, certain types of contributions to a retirement plan are subject to restrictions that generally limit distributions to a participant prior to the participant severing employment with the employer that sponsors the plan. This limitation on in-service distributions

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[5] See Rev. Rul. 69-136, 1969-1 C.B. 252.

[6] Treas. Reg. section 1.415(c)-2(e)(4), 72 F.R. 16878 (April 5, 2007).

[7] Section 403(b).

[8] Section 408(k).

applies to: (1) elective deferrals under a qualified cash or deferred compensation arrangement (a "section 401(k) plan"); (2) amounts attributable to a salary reduction agreement under a section 403(b) tax-sheltered annuity; (3) amounts contributed to a custodial account described in Code section 403(b)(7); and (4) amounts deferred under an eligible deferred compensation plan (described in Code section 457(b)).

USERRA

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which revised and restated the Federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service. Section 414(u) provides special rules that permit defined benefit plans and individual account plans to satisfy the requirements of USERRA. An individual account plan for this purpose is any defined contribution plan (such as a section 401(k) plan), and includes a section 403(b) tax sheltered annuity, a SEP, a qualified salary reduction arrangement under section 408(p) ("SIMPLE"), and an eligible deferred compensation plan (described in Code section 457(b)). Section 414(u) does not apply to a plan to which Chapter 43 of Title 38 of the United States Code does not apply.

IRA contributions

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[9] Under Code section 219, the total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2007); or (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount. For purposes of the IRA contribution limitations, compensation includes an individual's net earnings from self employment.

Description of Proposal

Wage withholding

The proposal amends the definition of wages for purposes of the Federal income tax withholding rules applicable to an employer's payment of wages. The proposal includes as wages the employer's payment of any differential wage payment to the employee. Differential wage payment is defined as any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and (2) represents all or a

[9] Secs. 408 and 408A.

portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.

Retirement plans

The proposal also provides rules relating to differential wage payments (as defined for purposes of wage withholding) for purposes of a retirement plan that is subject to section 414(u). Specifically, an individual receiving a differential wage payment is required to be treated as an employee of the employer making the payment and the differential wage payment is required to be treated as compensation. In addition, a retirement plan that is subject to section 414(u) is not treated as failing to meet certain requirements relating to minimum participation and nondiscrimination standards[10] by reason of any contribution or benefit that is based on the differential wage payment if all of the sponsoring employer's employees: (1) are entitled to differential wage payments on reasonably equivalent terms; and (2) if all employees eligible to participate in a retirement plan maintained by the employer are entitled to make contributions based on such differential payments on reasonably equivalent terms.

Under the proposal, an individual is treated as having been severed from employment during any period the individual is performing service in the uniformed services while on active duty for a period of more than 30 days for purposes of the limitation on in-service distributions with respect to: (1) elective deferrals under a section 401(k) plan; (2) amounts attributable to a salary reduction agreement under a section 403(b) tax-sheltered annuity; (3) amounts contributed to a custodial account described in Code section 403(b)(7); and (4) amounts deferred under an eligible deferred compensation plan (described in Code section 457(b)). Thus, such individuals are not prohibited from receiving distributions on account of not severing employment. However, if any amounts are distributed on account of the foregoing rule, the individual is not permitted to make elective deferrals or employee contributions to the plan during the six month period beginning on the date of distribution.

IRAs

For purposes of the limitation on contributions to an IRA, the proposal amends the term "compensation" to include differential wage payments (as defined for purposes of wage withholding).

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[10] These standards include the following: Section 401(a)(4) (prohibiting discrimination in contributions or benefits provided under qualified plans); section 401(a)(26) (providing minimum participation rules for qualified defined benefit plans); section 401(k)(3), (11), and (12) (providing discrimination rules for elective deferrals under qualified cash or deferred arrangements); section 401(m) (providing discrimination rules for employee contributions and employer matching contributions to qualified plans); 403(b)(12) (providing discrimination rules for section 403(b) tax sheltered annuities); section 408(k)(3), (k)(6), and (p) (providing discrimination rules for SEPs and SIMPLEs); section 410(b) (providing minimum coverage rules for qualified plans); and section 416 (requiring minimum benefits in the case of top heavy qualified plans).

Plan amendment timing

In general, the proposal permits a plan or annuity contract to be retroactively amended to comply with the proposal provided that the amendment is made no later than the last day of the first plan year beginning on or after January 1, 2009. Subject to certain conditions, a plan or annuity contract is treated as being operated in accordance with its terms during the period prior to amendment and, except as provided by the Secretary of the Treasury, the plan or annuity contract does not fail to meet the requirements of the Code or the Employee Retirement Income Security Act of 1974 (ERISA) by reason of the amendment.

Effective Date

For purposes of the wage withholding rules, the proposal is effective with respect to remuneration paid after December 31, 2007. Otherwise, the proposal is effective with respect to years beginning after December 31, 2007.

E. Tax Treatment Related to Certain Benefits Provided to Volunteer Firefighters and Emergency Medical Responders

<u>Certain tax reductions or tax rebates provided by a State or local government</u>

The Internal Revenue Service has provided guidance[11] that reductions or rebates of taxes by State or local governments on account of services performed by members of qualified volunteer emergency response organizations are taxable income to the taxpayers receiving these reductions or rebates of taxes.

<u>Deduction for certain State or local taxes</u>

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning before January 1, 2008, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes.

The otherwise allowable itemized deduction for these State or local taxes is not reduced by the amount of any reduction or rebate on account of services performed as a member of a qualified volunteer emergency response organization.

<u>Charitable deduction for certain expenses</u>

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3), to a Federal, State, or local governmental entity, or to certain other organizations.[12] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes.

<u>Description of Proposal</u>

<u>Certain tax reductions or tax rebates provided by a State or local government</u>

The bill provides an exclusion from gross income to members of qualified volunteer emergency response organizations for: (1) any qualified State or local tax benefit; and (2) any qualified reimbursement payment. A qualified State or local tax benefit is any reduction or

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[11] Chief Couns. Adv. 200302045 (Jan. 10, 2002)

[12] Sec. 170(a), (c), and (e).

rebate of certain taxes provided by State or local governments on account of services performed by individuals as members of a qualified volunteer emergency response organization. These taxes are limited to State or local income taxes, State or local real property taxes, and State or local personal property taxes. A qualified reimbursement payment is a payment provided by a State or political subdivision thereof on account of reimbursement for expenses incurred in connection with the performance of services as a member of a qualified volunteer emergency response organization. The amount of such qualified reimbursement payments is limited to $30 for each month during which the taxpayer performs such services.

A qualified volunteer emergency response organization is any volunteer organization: (1) which is organized and operated to provide firefighting or emergency medical services for persons in the State or its political subdivision; and (2) which is required (by written agreement) by the State or political subdivision to furnish firefighting or emergency medical services in such State or political subdivision.

<u>Denial of double benefits</u>

The bill provides that the amount of State or local taxes taken into account in determining the deduction for taxes is reduced by the amount of any qualified State or local tax benefit.

Also, the bill provides that expenses paid or incurred by the taxpayer in connection with the performance of services as a member of a qualified volunteer emergency response organization are taken into account for purposes of the charitable deduction only to the extent such expenses exceed the amount of any qualified reimbursement payment excluded from income under the bill.

<u>Effective Date</u>

The provision is effective for taxable years beginning after the date of enactment.

F. Extension of the Statute of Limitations to File Claims for Refunds Relating to Disability Determinations by the Department of Veterans Affairs

Present Law

In general, a taxpayer must file a claim for credit or refund within three years of the filing of the tax return or within two years of the payment of the tax, whichever expires later (if no tax return is filed, the two-year limit applies). A claim for credit or refund that is not filed within these time periods is rejected as untimely.

Generally, military retirement benefits based on length of service are included in income, whereas veterans' benefits based on a service-connected disability are excluded from income. If an individual receives includible retirement benefits and is later retroactively determined to be eligible for service-connected disability benefits, the portion of the retirement benefits attributable to the disability is retroactively excluded from income. In that case, the individual may claim a refund of the tax paid on the retroactively excluded benefits, subject to the statute of limitations on filing a refund claim.

Description of Proposal

The provision extends the time period for filing claims for credits or refunds for retired military personnel who receive disability determinations from the Department of Veterans Affairs (e.g., determinations after the tax return is filed). Specifically, in the case of a determination after the date of enactment, the provision extends the period for filing such a refund claim until one year after the date of the disability determination (if later than the time periods allowed under present law). The provision applies to any taxable year which begins five years before the date of the determination or thereafter. In the case of a determination after December 31, 2000, and on or before the date of enactment, the period for filing a claim for credit or refund is extended until one year after the date of enactment (if later than the time periods allowed under present law).

Effective Date

The provision is effective for claims for credits or refunds filed after the date of enactment.

G. Treatment of Distributions to Individuals Called to Active Duty for at Least 180 Days

Present Law

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Certain amounts held in a qualified cash or deferred arrangement (a "section 401(k) plan") or in a tax-sheltered annuity (a "section 403(b) annuity") may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee.

Pursuant to amendments to section 72(t) made by the Pension Protection Act of 2006,[13] the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a section 401(k) plan, section 403(b) annuity, or certain similar arrangements, (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the U.S. Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A section 401(k) plan or section 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to this special repayment rule. No deduction is allowed for any contribution made under the special repayment rule.

The special rules applicable to a qualified reservist distribution apply to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007.

Description of Proposal

The proposal extends the rules applicable to qualified reservist distributions to individuals ordered or called to active duty on or after December 31, 2007.

[13] Pub. L. No. 109-280.

Effective Date

The proposal is effective upon enactment.

H. Permanent Extension of Disclosure Authority to the Department of Veterans Affairs

Present Law

The Code prohibits disclosure of returns and return information, except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure of certain tax information to the Department of Veterans Affairs. Disclosure is permitted to assist the Department of Veterans Affairs in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The Department of Veterans Affairs disclosure provision was scheduled to expire after September 30, 2008.

Description of Proposal

The proposal makes the disclosure authority to the Department of Veteran's Affairs permanent.

Effective Date

The provision is effective on the date of enactment.

I. Contributions of Military Death Gratuities to Certain Tax-Favored Accounts

Present Law

Military death gratuities and SGLI

Section 1477 of Title 10 of the United States Code provides for the payment of a military death gratuity to an eligible survivor of a service member. Under Code section 134, as amended by the Military Family Tax Relief Act of 2003, the full amount of the military death gratuity is excludable from gross income. Pursuant to section 1967 of Title 38 of the United States Code, certain members of the uniformed services are automatically insured against death under the Servicemembers' Group Life Insurance ("SGLI") program. In general, life insurance proceeds are excludable from gross income under Code section 101.

Roth IRAs

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[14] In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. Contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59-½, death, or disability or which is a qualified special purpose distribution. A distribution is not a qualified distribution if it is made within the five-taxable year period beginning with the taxable year for which an individual first made a contribution to a Roth IRA.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2007); or (2) the amount of the individual's compensation that is includible in gross income for the year. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year.

As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2007 are: (1) for single taxpayers, $99,000 to $114,000; (2) for married taxpayers filing joint returns, $156,000 to $166,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

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[14] Traditional IRAs are described in Code sec. 408, and Roth IRAs in Code section 408A.

The foregoing contribution limitations generally do not apply in the case of a rollover contribution to an IRA. If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity,[15] or a governmental section 457 plan may roll over distributions from the plan or annuity into a traditional IRA. For distributions after December 31, 2007, certain taxpayers are permitted to make qualified rollover contributions from such plans or annuities into a Roth IRA (subject to inclusion in gross income of any amount that would be includible were it not part of the qualified rollover contribution).

Coverdell Education Savings Accounts

Annual contributions to a Coverdell education savings account[16] may not exceed $2,000 (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18. The maximum annual contribution that can be made to a Coverdell education savings account is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. Contributions to a Coverdell education savings account are not deductible. In general, a rollover is permitted between Coverdell education savings accounts for the benefit of the same beneficiary or member of such beneficiary's family.

In general, a distribution from a Coverdell education savings account is includible in the gross income of the distributee. However, distributions from an account are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. Contributions to a Coverdell education savings account are treated as nontaxable investment in the contract. Thus, earnings on contributions are subject to tax if amounts withdrawn from the account exceed qualified education expenses. The portion of a distribution from a Coverdell education savings account that is includible in income (i.e., the portion allocable to earnings on contributions when a distribution exceeds qualified education expenses) is generally subject to an additional 10-percent tax.

Description of Proposal

In the case of an individual who receives a military death gratuity or SGLI payment, the proposal permits the individual to contribute an amount no greater than the sum of the gratuity and SGLI payments received by the individual to a Roth IRA, notwithstanding the contributions limits that otherwise apply to contributions to Roth IRAs (e.g., the annual contribution limit and the income phase-out of the contribution dollar limit). The proposal also permits such an individual to contribute the gratuity and SGLI payments that the individual receives to one or more Coverdell education savings accounts, notwithstanding the $2,000 annual contribution limit and the income phase-out of the limit that would otherwise apply. The maximum amount that can be contributed to a Roth IRA or one or more Coverdell education savings accounts under the proposal is limited to the sum of the gratuity and SGLI payments that the individual receives.

[15] Sec. 403(b).

[16] Coverdell education savings accounts are described in Code sec. 530.

The contribution of a military death gratuity or SGLI payment to a Roth IRA is treated as a qualified rollover contribution to the Roth IRA. Similarly, the contribution of a military death gratuity or SGLI payment to a Coverdell education savings account is treated as a permissible rollover to such an account. The contribution of a military death gratuity or SGLI payment to a Roth IRA or Coverdell education savings account cannot be made later than one year after the date on which the gratuity or SGLI payment is received by the individual.

In the event of a subsequent distribution from a Roth IRA that is not a qualified distribution or a distribution from a Coverdell education savings account that is not a qualified education distribution, the amount of the distribution attributable to the contribution of the military death gratuity or SGLI payment is treated as nontaxable investment in the contract.

Effective Date

The proposal is generally effective with respect to payments made on account of deaths from injuries occurring on or after the date of enactment. In addition, the proposal permits the contribution to a Roth IRA or a Coverdell education savings account of a military death gratuity or SGLI payment received by an individual with respect to a death from injury occurring on or after October 7, 2001, and before the date of enactment of the proposal if the individual makes the contribution to the account no later than one year after the date of enactment of the proposal.

J. Exclusion of Gain on Sale of a Principal Residence by Certain Peace Corps Volunteers

Present Law

In general

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Uniformed services and Foreign Service

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Intelligence community

Specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. The five-year period may not be extended by more than 10 years.

The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

Description of Proposal

The bill creates a new rule for Peace Corps volunteers similar to the rules applicable to the uniformed services and Foreign Service and the intelligence community. Under this new rule, an individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to volunteer service in the Peace Corps. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is serving as a Peace Corps volunteer.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

II. IMPROVEMENTS IN SUPPLEMENTAL SECURITY INCOME

A. Ensure Equitable Treatment of Military Families Under SSI[17]

Present Law

Section 1612(a)(2) of the Social Security Act specifies that any income not defined as earned income by Section 1612(a)(1) of the act is considered unearned income. Section 1612(b)(20) of the Social Security Act excludes military hostile fire pay and imminent danger pay from the SSI income calculation.

Section SI 00830.540 of the POMS specifies the following regarding military compensation:

- Only military basic pay is considered earned income;
- Hostile fire pay and imminent danger pay are excluded from income;
- In deeming situations only, any other type of pay received for serving in a combat zone is excluded from income; and
- All other types of military pay are considered unearned income.

Section 1612(a)(2) of the Social Security Act specifies that ISM is considered unearned income by the SSI program. Section 1612(a)(2)(A) of the Social Security Act establishes the VTR rule and states that if a person is receiving ISM then his or her SSI benefit is reduced by one-third of the SSI federal benefit rate.

Section SI 00830.540 of the POMS specifies that payments made to or for a member of the uniformed services for housing at a military facility or for privatized military housing are considered ISM by the SSI program and subject to the SSA's Presumed Maximum Value (PMV) rule.

20 C.F.R. § 416.1140 establishes the PMV rule and states that if a person is subject to the PMV rule, then the value of the ISM provided to him or her is equal to the lesser of its actual value or one-third of the SSI federal benefit rate plus $20. The value of the ISM as determined by the PMV is considered unearned income.

Description of Proposal

The bill expands the definition of earned income for the SSI program to include all cash remuneration paid to members of the uniformed services and not otherwise excluded by law. Hostile fire pay and imminent danger would continue to be excluded from the SSI income calculation under the provision of Section 1612(b)(20) of the act.

[17] This description was not prepared by the staff of the Joint Committee on Taxation. It was provided by the majority staff of the House Committee on Ways and Means, Subcommittee on Income Security and Family Support.

The bill also specifies that any payments made to or for a member of the uniformed services for housing at a military facility or for privatized military housing shall be considered as in-kind support and maintenance (ISM) by the SSI program and subject to the One-Third Reduction (VTR) rule.

Effective Date

The provision is effective with respect to benefits payable for months beginning after 60 days after the date of the enactment.

B. Remove Penalties for Blind Veterans Under SSI[18]

Present Law

Section 1612(b) of the Social Security Act provides a list of income exclusions and contains no reference to State annuities for blind veterans. 20 C.F.R. § 416.1121 specifies that annuities and veterans benefits are considered unearned income by the SSI program unless excluded by law.

Section 1613(a) of the Social Security Act provides a list of resource exclusions and contains no reference to state annuities for blind veterans. 20 C.F.R § 416.1201 specifies that any cash or liquid asset or any real or personal property that a person owns and could convert into cash is considered a resource by the SSI program unless excluded by law.

Description of Proposal

The bill specifies that any money paid by a state to a blind veteran is excluded from the SSI income calculation. The bill also specifies that the value of any money paid by a state to a blind veteran in a given month shall not be counted as a resource by the SSI program in that month.

Effective Date

The provision is effective with respect to benefits payable for months beginning after 60 days after the date of the enactment.

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[18] This description was not prepared by the staff of the Joint Committee on Taxation. It was provided by the majority staff of the House Committee on Ways and Means, Subcommittee on Income Security and Family Support.

C. Exclusion of Benefits for Americorps Volunteers Under SSI[19]

Present Law

Section 1612(b) of the Social Security Act provides a list of income exclusions and contains no reference to the AmeriCorps program. 42 U.S.C. § 5044(f) specifies that payments made to volunteers in programs authorized under Chapter 66 of Title 42 of the United States Code are excluded from the SSI income calculation. The AmeriCorps*VISTA program, but not the AmeriCorps program falls under this exclusion (AmeriCorps*VISTA and AmeriCorps are different programs).

Section SI 00830.537 of the POMS establishes the following rules for the treatment of Americorps payments:

- AmeriCorps stipends or living allowance payments are considered earned income;
- Food or shelter provided to AmeriCorps participants is ISM subject to the PMV rule;
- AmeriCorps education awards used for education expenses are excluded from the SSI income calculation under the provisions of Section 1612(b)(7) of the Social Security Act;
- Any part of an AmeriCorps education award not used for education expenses is considered earned income; and
- Payments made in lieu of an education award are considered earned income.

Description of Proposal

The bill specifies that any cash or in-kind benefit paid to a participant in the AmeriCorps program is excluded from the SSI income calculation.

Effective Date

The provision is effective with respect to benefits payable for months beginning after 60 days after the date of the enactment.

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[19] This description was not prepared by the staff of the Joint Committee on Taxation. It was provided by the majority staff of the House Committee on Ways and Means, Subcommittee on Income Security and Family Support.

III. REVENUE RAISING PROPOSALS

A. Increase in Penalty for Failure to File Partnership Returns

Present Law

A partnership generally is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under present law, a partnership is required to file a tax return for each taxable year. The partnership's tax return is required to include the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual. In addition to applicable criminal penalties, present law imposes a civil penalty for the failure to timely file a partnership return. The penalty is $50 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of five months.

Description of Proposal

Under the proposal, the period for calculating the monthly failure to file penalty for partnership returns is extended from five months to 12 months and the penalty amount is increased to $100 per partner.

Effective Date

The proposal applies to returns required to be filed after the date of enactment.

B. Penalty for Failure to File S Corporation Returns

Present Law

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns.

Under present law, S corporations are required to file a tax return for each taxable year. The S corporation's tax return is required to include the following: the names and addresses of all persons owning stock in the corporation at any time during the taxable year; the number of shares of stock owned by each shareholder at all times during the taxable year; the amount of money and other property distributed by the corporation during the taxable year to each shareholder and the date of such distribution; each shareholder's pro rata share of each item of the corporation for the taxable year; and such other information as the Secretary may require.

Description of Proposal

The proposal imposes a monthly penalty for any failure to timely file an S corporation return or any failure to provide the information required to be shown on such a return. The penalty is $100 times the number of shareholders in the S corporation during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months.

Effective Date

The proposal applies to returns required to be filed after the date of enactment.

C. Increase in Information Return Penalties

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721 of the Code, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the “first-tier penalty”), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return more than 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the “second-tier penalty”), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, of any year, the amount of the penalty is $50 per return (the “third-tier penalty”), with a maximum penalty of $250,000 per calendar year.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 of the Code also imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Description of Proposal

The proposal increases the penalties for failing to file correct information returns, for failing to furnish correct payee statements, and for failing to comply with other information reporting requirements. Specifically, the proposal increases the penalties for failing to file correct information returns as follows: the first-tier penalty would be increased from $15 to $25, with a maximum penalty of $200,000 per calendar year; the second-tier penalty would be increased from $30 to $60, with a maximum penalty of $400,000 per calendar year; and the third-tier penalty would be increased from $50 to $100, with a maximum penalty of $600,000 per calendar year. The maximum penalties for small businesses would be: $75,000 if the failures are corrected on or before 30 days after the prescribed filing date; $150,000 if the failures are corrected on or before August 1; and $250,000 if the failures are not corrected on or before August 1.

The proposal increases both the penalty for failing to furnish correct payee statements to taxpayers and the penalty for failing to comply with other information reporting requirements penalties to $100 for each such failure, up to a maximum of $600,000 in a calendar year.

The proposal also increases the minimum penalty for intentional disregard of the information reporting requirements to $250 per return.

Effective Date

The proposal is effective with respect to information returns required to be filed on or after January 1, 2008.

D. Minimum Failure to File Penalty

Present Law

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.[20] An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.[21]

In the case of a failure to file a tax return within 60 days of the due date, present law imposes a minimum penalty equal to the lesser of $100 or 100 percent of the amount of tax required to be shown on the return.

Description of Proposal

The proposal increases the minimum penalty for a failure to file a tax return within 60 days of the due date to the lesser of $225 or 100 percent of the amount of tax required to be shown on the return.

Effective Date

The proposal is effective for tax returns the due date for which (including extensions) is after December 31, 2007.

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[20] Sec. 6651(a)(1).

[21] Sec. 6651(b)(1).