

[JOINT COMMITTEE PRINT]

**GENERAL EXPLANATION OF
TAX LEGISLATION
ENACTED IN THE 107TH CONGRESS**

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION



JANUARY 24, 2003

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS

[JOINT COMMITTEE PRINT]

**GENERAL EXPLANATION OF
TAX LEGISLATION
ENACTED IN THE 107TH CONGRESS**

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION



JANUARY 24, 2003

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 2003

83-912

JCS-1-03

JOINT COMMITTEE ON TAXATION

107TH CONGRESS, 2ND SESSION

SENATE

MAX BAUCUS, Montana,
Chairman
JOHN D. ROCKEFELLER IV, West Virginia
TOM DASCHLE, South Dakota
CHARLES E. GRASSLEY, Iowa
ORRIN G. HATCH, Utah

HOUSE

WILLIAM M. THOMAS, California,
Vice Chairman
PHILIP M. CRANE, Illinois
E. CLAY SHAW, JR., Florida
CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California

LINDY L. PAULL, *Chief of Staff*
BERNARD A. SCHMITT, *Deputy Chief of Staff*
MARY M. SCHMITT, *Deputy Chief of Staff*

SUMMARY CONTENTS

	Page
Part One: The Fallen Hero Survivor Benefit Fairness Act of 2001 (Public Law 107-15)	3
Part Two: Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16)	5
Part Three: An Act To Amend the Internal Revenue Code of 1986 To Rename The Education Individual Retirement Accounts as the Coverdell Education Savings Accounts (Public Law 107-22)	173
Part Four: The Revenue Provisions of the Railroad Retirement and Survivors' Improvement Act of 2001 (Public Law 107-90)	175
Part Five: The Revenue Provisions of an Act Making Appropriations for the Departments of Labor, Health and Human Services, and Education, and Related Agencies for the Fiscal Year Ending September 30, 2002, and for Other Purposes (Public Law 107-116)	179
Part Six: An Act To Amend the Internal Revenue Code of 1986 To Simplify the Reporting Requirements Relating to Higher Education Tuition and Related Expenses (Public Law 107-131)	181
Part Seven: Victims of Terrorism Tax Relief Act of 2001 (Public Law 107-134)	183
Part Eight: Job Creation and Worker Assistance Act of 2002 (Public Law 107-147)	217
Part Nine: The Clergy Housing Allowance Clarification Act of 2002 (Public Law 107-181)	285
Part Ten: Revenue Provision of the Trade Adjustment Assistance Reform Act of 2002 (Public Law 107-210) .	287
Part Eleven: An Act Relating to Political Organizations Described in Section 527 of the Internal Revenue Code (Public Law 107-276)	293
Part Twelve: The Revenue Provisions of the Homeland Security Act of 2002 (Public Law 107-296)	300
Part Thirteen: The Revenue Provisions of the Veterans Benefits Improvement Act of 2002 (Public Law 107-330)	302

	Page
Part Fourteen: The Holocaust Restitution Tax Fairness Act of 2002 (Public Law 107-358)	304
Appendix: Estimated Budget Effects of Tax Legislation Enacted in the 107th Congress	307

CONTENTS

	Page
Introduction	1
Part One: The Fallen Hero Survivor Benefit Fairness Act of 2001 (Public Law 107-15)	3
Part Two: Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16)	5
I. Marginal Tax Rate Reduction	5
A. Individual Income Tax Rate Structure (sec. 101 of the Act and sec. 1 of the Code)	5
B. Phased-in Repeal of the Phase-Out of Itemized Deductions (sec. 102 of the Act and sec. 68 of the Code)	12
C. Phased-in Repeal of the Personal Exemption Phaseout (sec. 103 of the Act and sec. 151(d)(3) of the Code)	13
II. Tax Benefits Relating to Children	16
A. Increase and Expand the Child Tax Credit (sec. 201 of the Act and sec. 24 of the Code) ...	16
B. Extension and Expansion of Adoption Tax Benefits (secs. 202 and 203 of the Act and secs. 23 and 137 of the Code)	18
C. Expansion of Dependent Care Tax Credit (sec. 204 of the Act and sec. 21 of the Code)	21
D. Tax Credit for Employer-Provided Child Care Facilities (sec. 303 of the Act and new sec. 45D of the Code)	23
III. Marriage Penalty Relief Provisions	25
A. Standard Deduction Marriage Penalty Relief (sec. 301 of the Act and sec. 63 of the Code) ...	25
B. Expansion of the 15-Percent Rate Bracket For Married Couples Filing Joint Returns (sec. 302 of the Act and sec. 1 of the Code)	27
C. Marriage Penalty Relief and Simplification Relating to the Earned Income Credit (sec. 303 of the Act and sec. 32 of the Code)	28

	Page
IV. Affordable Education Provisions	35
A. Education Individual Retirement Accounts (sec. 401 of the Act and sec. 530 of the Code) .	35
B. Private Prepaid Tuition Programs; Exclusion From Gross Income of Education Distribu- tions From Qualified Tuition Programs (sec. 402 of the Act and sec. 529 of the Code)	40
C. Exclusion for Employer-Provided Educational Assistance (sec. 411 of the Act and sec. 127 of the Code)	45
D. Modifications to Student Loan Interest Deduc- tion (sec. 412 of the Act and sec. 221 of the Code)	46
E. Eliminate Tax on Awards Under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (sec. 413 of the Act and sec. 117 of the Code)	48
F. Liberalization of Tax-Exempt Financing Rules for Public School Construction (secs. 421–422 of the Act and secs. 142 and 146–148 of the Code)	49
G. Deduction for Qualified Higher Education Ex- penses (sec. 431 of the Act and new sec. 222 of the Code)	54
V. Estate, Gift, and Generation-Skipping Transfer Tax Provisions	57
A. Phaseout and Repeal of Estate and Genera- tion-Skipping Transfer Taxes; Increase in Gift Tax Unified Credit Effective Exemption (secs. 501, 511, 521, 531, 532, 541 and 542 of the Act, secs. 121, 684, 1014, 1040, 1221, 2001– 2210, 2501, 2502, 2503, 2505, 2511, 2601– 2663, 4947, 6018, 6019, and 7701 of the Code, and new secs. 1022, 2058, 2210, 2664, and 6716 of the Code)	57
B. Expand Estate Tax Rule for Conservation Easements (sec. 551 of the Act and sec. 2031 of the Code)	72
C. Modify Generation-Skipping Transfer Tax Rules	73

VII

	Page
1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips (sec. 561 of the Act and sec. 2632 of the Code)	73
2. Retroactive allocation of the generation-skipping transfer tax exemption (sec. 561 of the Act and sec. 2632 of the Code)	76
3. Severing of trusts holding property having an inclusion ratio of greater than zero (sec. 562 of the Act and sec. 2642 of the Code)	78
4. Modification of certain valuation rules (sec. 563 of the Act and sec. 2642 of the Code) .	79
5. Relief from late elections (sec. 564 of the Act and sec. 2642 of the Code)	80
6. Substantial compliance (sec. 564 of the Act and sec. 2642 of the Code)	81
D. Expand and Modify Availability of Installment Payment of Estate Tax for Closely-Held Businesses (secs. 571, 572 and 573 of the Act and sec. 6166 of the Code)	82
E. Waiver of Statute of Limitations for Refunds of Recapture of Estate Tax (sec. 581 of the Act and sec. 2032A of the Code)	84
VI. Pension and Individual Retirement Arrangement Provisions	86
A. Individual Retirement Arrangements (“IRAs”) (secs. 601–602 of the Act and secs. 219, 408, and 408A of the Code)	86
B. Pension Provisions	89
1. Expanding coverage	89
(a) Increase in benefit and contribution limits (sec. 611 of the Act and secs. 401(a)(17), 401(c)(2), 402(g), 408(p), 415 and 457 of the Code)	89
(b) Plan loans for S corporation shareholders, partners, and sole proprietors (sec. 612 of the Act and sec. 4975 of the Code)	93
(c) Modification of top-heavy rules (sec. 613 of the Act and sec. 416 of the Code)	95
(d) Elective deferrals not taken into account for purposes of deduction limits (sec. 614 of the Act and sec. 404 of the Code)	99

VIII

	Page
(e) Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations (sec. 615 of the Act and sec. 457 of the Code)	100
(f) Deduction limits (sec. 616 of the Act and sec. 404 of the Code)	101
(g) Option to treat elective deferrals as after-tax contributions (sec. 617 of the Act and new sec. 402A of the Code)	103
(h) Nonrefundable credit to certain individuals for elective deferrals and IRA contributions (sec. 618 of the Act and new sec. 25B of the Code)	106
(i) Small business tax credit for new retirement plan expenses (sec. 619 of the Act and new sec. 45E of the Code)	108
(j) Eliminate IRS user fees for certain determination letter requests regarding employer plans (sec. 620 of the Act) ..	109
(k) Certain nonresident aliens excluded in applying minimum coverage requirements (sec. 621 of the Act and secs. 410(b)(3) and 861(a)(3) of the Code)	111
2. Enhancing fairness for women	112
(a) Additional salary reduction catch-up contributions (sec. 631 of the Act and sec. 414 of the Code)	112
(b) Equitable treatment for contributions of employees to defined contribution plans (sec. 632 of the Act and secs. 403(b), 415, and 457 of the Code)	114
(c) Faster vesting of employer matching contributions (sec. 633 of the Act and sec. 411 of the Code)	117
(d) Modifications to minimum distribution rules (sec. 634 of the Act and sec. 401(a)(9) of the Code)	118
(e) Clarification of tax treatment of division of section 457 plan benefits upon divorce (sec. 635 of the Act and secs. 414(p) and 457 of the Code)	120
(f) Provisions relating to hardship withdrawals (sec. 636 of the Act and secs. 401(k) and 402 of the Code)	121
(g) Pension coverage for domestic and similar workers (sec. 637 of the Act and sec. 4972(c)(6) of the Code)	123
3. Increasing portability for participants	125

	Page
(a) Rollovers of retirement plan and IRA distributions (secs. 641–643 and 649 of the Act and secs. 401, 402, 403(b), 408, 457, and 3405 of the Code)	125
(b) Waiver of 60-day rule (sec. 644 of the Act and secs. 402 and 408 of the Code)	129
(c) Treatment of forms of distribution (sec. 645 of the Act and sec. 411(d)(6) of the Code)	130
(d) Rationalization of restrictions on distributions (sec. 646 of the Act and secs. 401(k), 403(b), and 457 of the Code)	133
(e) Purchase of service credit under governmental pension plans (sec. 647 of the Act and secs. 403(b) and 457 of the Code)	135
(f) Employers may disregard rollovers for purposes of cash-out rules (sec. 648 of the Act and sec. 411(a)(11) of the Code)	136
(g) Minimum distribution and inclusion requirements for section 457 plans (sec. 649 of the Act and sec. 457 of the Code)	137
4. Strengthening pension security and enforcement	138
(a) Phase in repeal of 160 percent of current liability funding limit; deduction for contributions to fund termination liability (secs. 651–652 of the Act and secs. 404(a)(1), 412(c)(7), and 4972(c) of the Code)	138
(b) Excise tax relief for sound pension funding (sec. 653 of the Act and sec. 4972 of the Code)	140
(c) Modifications to section 415 limits for multiemployer plans (sec. 654 of the Act and sec. 415 of the Code)	141
(d) Investment of employee contributions in 401(k) plans (sec. 655 of the Act and sec. 1524(b) of the Taxpayer Relief Act of 1997)	142
(e) Prohibited allocations of stock in an S corporation ESOP (sec. 656 of the Act and secs. 409 and 4979A of the Code)	144
(f) Automatic rollovers of certain mandatory distributions (sec. 657 of the Act and secs. 401(a)(31) and 402(f)(1) of the Code and sec. 404(c) of ERISA)	147

	Page
(g) Clarification of treatment of contributions to a multiemployer plan (sec. 658 of the Act)	149
(h) Notice of significant reduction in plan benefit accruals (sec. 659 of the Act and new sec. 4980F of the Code)	150
5. Reducing regulatory burdens	153
(a) Modification of timing of plan valuations (sec. 661 of the Act and sec. 412 of the Code)	153
(b) ESOP dividends may be reinvested without loss of dividend deduction (sec. 662 of the Act and sec. 404 of the Code)	154
(c) Repeal transition rule relating to certain highly compensated employees (sec. 663 of the Act and sec. 1114(c)(4) of the Tax Reform Act of 1986)	156
(d) Employees of tax-exempt entities (sec. 664 of the Act)	157
(e) Treatment of employer-provided retirement advice (sec. 665 of the Act and sec. 132 of the Code)	158
(f) Repeal of the multiple use test (sec. 666 of the Act and sec. 401(m) of the Code)	159
C. Tax Treatment of Electing Alaska Native Settlement Trusts (sec. 671 of the Act and new sections 646 and 6039H of the Code, modifying Code sections including 1(e), 301, 641, 651, 661, and 6034A)	161
VII. Alternative Minimum Tax	166
A. Individual Alternative Minimum Tax Relief (sec. 701 of the Act and sec. 55 of the Code) ...	166
VIII. Other Provisions	168
A. Modification to Corporate Estimated Tax Requirements (sec. 801 of the Act)	168
B. Authority to Postpone Certain Tax-Related Deadlines by Reason of Presidentially Declared Disaster (sec. 802 of the Act and sec. 7508A of the Code)	168
C. Income Tax Treatment of Certain Restitution Payments to Holocaust Victims (sec. 803 of the Act)	169
IX. Compliance With Congressional Budget Act (Sec. 901 of the Act)	171

	Page
Part Three: An Act to Amend the Internal Revenue Code of 1986 To Rename the Education Individual Retirement Accounts as the Coverdell Education Savings Accounts (Public Law 107-22)	173
A. Education Individual Retirement Accounts (sec. 1 of the Act and sec. 530 of the Code)	173
Part Four: The Revenue Provisions of the Railroad Retirement and Survivors' Improvement Act of 2001 (Public Law 107-90)	175
A. Amendments to the Internal Revenue Code of 1986 (secs. 201-204 of the Act and secs. 501, 3201, 3211, 3221, and 3241 of the Code)	175
Part Five: The Revenue Provisions of an Act Making Appropriations for the Departments of Labor, Health and Human Services, and Education, and Related Agencies for the Fiscal Year Ending September 30, 2002, and for Other Purposes (Public Law 107-116)	179
A. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 701 of the Act and sec. 9812(f) of the Code)	179
Part Six: An Act to Amend the Internal Revenue Code of 1986 to Simplify the Reporting Requirements Relating to Higher Education Tuition and Related Expenses (Public Law 107-131)	181
A. Simplify the Reporting Requirements Relating to Higher Education Tuition and Related Expenses (sec. 1 of the Act and sec. 6050S of the Code)	181
Part Seven: Victims of Terrorism Tax Relief Act of 2001 (Public Law 107-134)	183
I. Relief Provisions for Victims of Specific Terrorist Attacks	183
A. Reasons for Change	183
B. Income Taxes of Victims of Terrorist Attacks (sec. 101 of the Act and sec. 692 of the Code) .	184
C. Exclusion of Certain Death Benefits (sec. 102 of the Act and sec. 101 of the Code)	186
D. Estate Tax Reduction (sec. 103 of the Act and sec. 2201 of the Code)	187
E. Payments by Charitable Organizations Treated as Exempt Payments (sec. 104 of the Act and secs. 501 and 4941 of the Code)	189
F. Exclusion for Certain Cancellations of Indebtedness (sec. 105 of the Act)	191

	Page
II. Other Relief Provisions	194
A. Reasons for Change	194
B. Exclusion of Disaster Relief Payments (sec. 111 of the Act and new sec. 139 of the Code)	194
C. Authority to Postpone Certain Deadlines and Required Actions (sec. 122 of the Act, sec. 7508A of the Code, and new sec. 518 and sec. 4002 of the Employee Retirement Income Security Act of 1974)	200
D. Application of Certain Provisions to Terroristic or Military Actions (sec. 113 of the Act and secs. 104 and 692 of the Code)	202
E. Clarification that the Special Deposit Rules Provided Under the Air Transportation Safety and Stabilization Act Do Not Apply to Em- ployment Taxes (sec. 114 of the Act and sec. 301 of the Air Transportation Safety and Sta- bilization Act)	203
F. Treatment of Purchase of Structured Settle- ments (sec. 115 of the Act and new sec. 5891 of the Code)	204
G. Personal Exemption Deduction for Certain Dis- ability Trusts (sec. 116 of the Act and sec. 642 of the Code)	206
III. Disclosure of Tax Information in Terrorism and Na- tional Security Investigations (sec. 201 of the Act and sec. 6103 of the Code)	209
IV. No Impact on Social Security Trust Funds (sec. 301 of the Act)	216
Part Eight: Job Creation and Worker Assistance Act of 2002 (Public Law 107-147)	217
Title I. Business Provisions	217
A. Special Depreciation Allowance for Certain Property (sec. 101 of the Act and sec. 168 of the Code)	217
B. Five-Year Carryback of Net Operating Losses (sec. 102 of the Act and secs. 172 and 56 of the Code)	220
Title II. Tax Benefits for Area of New York City Damaged in Terrorist Attacks on September 11, 2001	223
A. Expansion of Work Opportunity Tax Credit Targeted Categories to Include Certain Employees in New York City (sec. 301 of the Act and new sec. 1400L(a) of the Code)	223

	Page
B. Special Depreciation Allowance for Certain Property (sec. 301 of the Act and new sec. 1400L(b) of the Code)	225
C. Treatment of Qualified Leasehold Improvement Property (sec. 301 of the Act and new sec. 1400L of the Code)	228
D. Authorize Issuance of Tax-Exempt Private Activity Bonds for Rebuilding the Portion of New York City Damaged in the September 11, 2001, Terrorist Attack (sec. 301 of the Act and new sec. 1400L(d) of the Code)	229
E. Allow One Additional Advance Refunding for Certain Previously Refunded Bonds for Facilities Located in New York City (sec. 301 of the Act and sec. 1400L(d) of the Code)	233
F. Increase in Expensing Treatment for Business Property Used in the New York Liberty Zone (sec. 301 of the Act and new sec. 1400L of the Code)	235
G. Extension of Replacement Period for Certain Property Involuntarily Converted in the New York Liberty Zone (sec. 301 of the Act and new sec. 1400L of the Code)	236
Title III. Miscellaneous and Technical Provisions	238
Subtitle A—General Miscellaneous Provisions	238
A. Allowance of Electronic Forms 1099 (sec. 401 of the Act)	238
B. Discharge of Indebtedness of an S Corporation (sec. 402 of the Act and sec. 108 of the Code)	238
C. Limitation on Use of Non-Accrual Experience Method of Accounting (sec. 403 of the Act and sec. 448 of the Code)	240
D. Expansion of the Exclusion from Income for Qualified Foster Care Payments (sec. 404 of the Act and sec. 131 of the Code)	243
E. Interest Rate Used in Determining Additional Required Contributions to Defined Benefit Plans and PBGC Variable Rate Premiums (sec. 405 of the Act, sec. 412 of the Code, and secs. 302 and 4006 of ERISA)	244
F. Adjusted Gross Income Determined by Taking into Account Certain Expenses of Elementary and Secondary School Teachers (sec. 406 of the Act and sec. 62 of the Code)	246
Subtitle B—Tax Technical and Additional Corrections	247

	Page
A. Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001 (sec. 411(a)–(h) of the Act)	248
1. Section 6428 credit interaction with refundable child tax credit	248
2. Child tax credit	248
3. Transition rule for adoption tax credit	248
4. Dollar amount of credit for special needs adoptions	248
5. Employer-provided adoption assistance exclusion with respect to special needs adoptions	248
6. Credit for employer expenses for child care assistance	249
7. Elimination of marriage penalty in standard deduction	249
8. Education IRAs; non-application of 10-percent additional tax with respect to amounts for which HOPE credit is claimed	249
9. Transfers in trust	249
10. Recovery of taxes claimed as credit (State death tax credit)	250
B. Pension-Related Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001 (sec. 411(i)–(w) of the Act)	250
1. Individual Retirement Arrangements (“IRAs”)	250
2. Increase in benefit and contribution limits	250
3. Modification of top-heavy rules	251
4. Elective deferrals not taken into account for deduction limits	251
5. Deduction limits	251
6. Nonrefundable credit for certain individuals for elective deferrals and IRA contributions	251
7. Small business tax credit for new retirement plan expenses	252
8. Additional salary reduction catch-up contributions	252
9. Equitable treatment for contributions of employees to defined contribution plans	252
10. Rollovers of retirement plan and IRA distributions	253
11. Employers may disregard rollovers for purposes of cash-out amounts	253
12. Notice of significant reduction in plan benefit accruals	253
13. Modification of timing of plan valuation	254
14. ESOP dividends may be reinvested without loss of dividend deduction	254
C. Amendments to the Community Renewal Tax Relief Act of 2000 (sec. 412 of the Act)	254
1. Phaseout of \$25,000 amount for certain rental real estate under passive loss rules	254
2. Treatment of missing children	255

	Page
3. Basis of property in an exchange by a corporation involving assumption of liabilities	255
4. Tax treatment of securities futures contracts	255
D. Amendment to the Tax Relief Extension Act of 1999 (sec. 413 of the Act)	256
1. Taxable REIT subsidiaries—100 percent tax on improperly allocated amounts	256
E. Amendments to the Taxpayer Relief Act of 1997 (sec. 414 of the Act)	256
1. Election to recognize gain on assets held on January 1, 2001; treatment of gain on sale of principal residence	256
2. Election to recognize gain on assets held on January 1, 2001; treatment of disposition of interest in passive activity	256
F. Amendment to the Balanced Budget Act of 1997 (sec. 415 of the Act)	256
1. Medicare+Choice MSA	256
G. Amendment to other Acts (sec. 416 of the Act)	257
1. Advance payments of earned income credit	257
2. Coordination of wash sale rules and section 1256 contracts	257
3. Disclosure by the Social Security Administration to Federal child support enforcement agencies ...	257
4. Treatment of settlements under partnership audit rules	257
5. Clarification of permissible extension of limitations period for installment agreements	258
6. Determination of whether a life insurance contract is a modified endowment contract	258
H. Clerical Amendments (sec. 417 of the Act)	259
I. Additional Corrections (sec. 418 of the Act)	259
1. Adoption credit and employer-provided adoption assistance exclusion rounding rules	259
2. Dependent care credit	259
Title IV. No Impact on Social Security Trust Funds (Sec. 501 of the Act)	260
Title V. Emergency Designation (Sec. 502 of the Act)	261
Title VI. Extensions of Expiring Provisions	262
A. Extend Alternative Minimum Tax Relief for Individuals (sec. 601 of the Act and sec. 26 of the Code)	262
B. Extend Credit for Purchase of Qualified Electric Vehicles (sec. 602 of the Act and secs. 30 and 280F of the Code)	263

	Page
C. Extend Section 45 Credit for Production of Electricity from Wind, Closed Loop Biomass, and Poultry Litter (sec. 603 of the Act and sec. 45 of the Code)	264
D. Extend the Work Opportunity Tax Credit (sec. 604 of the Act and sec. 51 of the Code)	265
E. Extend the Welfare-To-Work Tax Credit (sec. 605 of the Act and sec. 51A of the Code)	266
F. Extend Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean-Fuel Vehicle Refueling Property (sec. 606 of the Act and secs. 179A and 280F of the Code)	268
G. Taxable Income Limit on Percentage Depletion for Marginal Production (sec. 607 of the Act and sec. 613A of the Code)	269
H. Extension of Authority to Issue Qualified Zone Academy Bonds (sec. 608 of the Act and sec. 1397E of the Code)	271
I. Extension of Increased Coverover Payments to Puerto Rico and the Virgin Islands (sec. 609 of the Act and sec. 7652 of the Code)	272
J. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 610 of the Act and sec. 9812(f) of the Code)	273
K. Suspension of Reduction of Deductions for Mutual Life Insurance Companies (sec. 611 of the Act and sec. 809 of the Code)	274
L. Extension of Archer Medical Savings Accounts (“MSAs”) (sec. 612 of the Act and sec. 220 of the Code)	275
M. Extension of Tax Incentives for Investment on Indian Reservations (sec. 613 of the Act and secs. 45A and 168(j) of the Code)	278
N. Extension and Modification of Exceptions under Subpart F for Active Financing Income (sec. 614 of the Act, and secs. 953 and 954 of the Code)	279
O. Repeal of Dyed-Fuel Requirement for Registered Diesel or Kerosene Terminals (sec. 615 of the Act and sec. 4101 of the Code)	283
Part Nine: The Clergy Housing Allowance Clarification Act of 2002 (Public Law 107-181)	285
Part Ten: Revenue Provisions of the Trade Adjustment Assistance Reform Act of 2002 (Public Law 107-210) .	287

	Page
I. Refundable Credit for Health Insurance Costs of Eligible Individuals (Secs. 201(a), 202 and 203 of the Act and new secs. 35, 6050T, 6103(l)(18), and 7527 of the Code)	287
Part Eleven: An Act Relating to Political Organizations Described in Section 527 of the Internal Revenue Code (Public Law 107-276)	293
Part Twelve: The Revenue Provisions of the Homeland Security Act of 2002 (Public Law 107-296)	300
A. Transfer of Certain Functions of the Bureau of Alcohol, Tobacco and Firearms to the Department of Justice (secs. 1111 and 1112 of the Act and secs. 6103, 7801, chapter 53 and chapters 61 through 80 of the Code)	300
Part Thirteen: The Revenue Provisions of the Veterans Benefits Improvement Act of 2002 (Public Law 107-330)	302
A. Disclosure of Tax Return Information for Administration of Certain Veterans Programs (sec. 306 of the Act and sec. 6103(l) of the Code)	302
Part Fourteen: The Holocaust Restitution Tax Fairness Act of 2002 (Public Law 107-358)	304
Appendix: Estimated Budget Effects of Tax Legislation Enacted in the 107th Congress	307

INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means and Senate Committee on Finance, provides an explanation of tax legislation enacted in the 107th Congress. The explanation follows the chronological order of the tax legislation as signed into law.

A committee report on legislation issued by a Congressional committee sets forth the committee's explanation of the bill as it was reported by that committee. In some instances, a committee report does not serve as an explanation of the final provisions of the legislation as enacted. This is because the version of the bill enacted after action by the Conference Committee may differ significantly from the versions of the bill reported by the House and Senate Committees and passed by the House and Senate. The material contained in this document is prepared so that Members of Congress, tax practitioners, and other interested parties can have an explanation in one document of the final tax legislation enacted in 107th Congress.

In some instances, provisions included in legislation enacted in the 107th Congress were not reported out of committee before enactment. As a result, the legislative history of such provisions does not include the reasons for change normally included in a committee report. In the case of such provisions, no reasons for change are included with the explanation of the provision in this document.

Part One of the document is an explanation of the provisions of the Fallen Hero Survivor Benefit Tax Fairness Act of 2001 (Pub. L. No. 107-15), relating to consistent tax treatment of survivor benefits for public safety officers killed in the line of duty. Part Two is an explanation of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16) relating to individual income tax relief, affordable education revenue provisions, estate, gift and generation skipping transfer tax repeal, pension and individual retirement arrangement provisions, alternative minimum tax relief and other revenue provisions. Part Three is an explanation of the revenue provision renaming education individual retirement accounts as the Coverdell educational savings accounts (Pub. L. No. 107-22). Part Four is an explanation of the revenue provisions of the Railroad Retirement and Survivors' Improvement Act of 2001 (Pub. L. No. 107-90), relating to an act to modernize the railroad retirement and to provide enhanced benefits to employees and beneficiaries. Part Five is an explanation of the excise tax provision relating to the mental health parity requirements in-

¹This pamphlet may be cited as follows: Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 107th Congress (JCS-1-03), January 24, 2003.

cluded in the Fiscal Year 2002 Appropriation for the Departments of Labor, Health and Human Services, and Education (Pub. L. No. 107–116). Part Six is an explanation of the Act to simplify the reporting requirements relating to higher education tuition and related expenses (Pub. L. No. 107–131). Part Seven is an explanation of the Victims of Terrorism Tax Relief Act of 2001 (Pub. L. No. 107–134), relating to tax relief provisions for victims of terrorist attacks and other purposes. Part Eight is an explanation of the revenue provisions of the Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107–147), relating to provide incentives to general economic recovery, tax incentives for New York City and distressed areas, general miscellaneous provisions, tax technical corrections, and the extension of certain expiring provisions. Part Nine is an explanation of the Clergy Housing Allowance Clarification Act of 2002 (Pub. L. No. 107–181), relating to the parsonage allowance exclusion. Part Ten is the revenue provision of the Trade Adjustment Assistance Reform Act of 2002 (Pub. L. No. 107–210), relating to the credit for health insurance costs of eligible individuals. Part Eleven is an explanation of provisions of an Act amending section 527 of the Internal Revenue Code (the “Code”) to eliminate notification and return requirements for State and local party committees and candidate committees and to avoid duplicate reporting by certain State and local political committees of information required to be reported and made publicly available under State law (Pub. L. No. 107–276). Part Twelve is the revenue provisions of the Homeland Security Act of 2002 (Pub. L. No. 107–296) relating to the transfer of the Bureau of Alcohol, Tobacco and Firearms to the Department of Justice. Part Thirteen is the revenue provisions of the Veterans’ Benefits Act of 2002 (Pub. L. No. 107–330) relating to the extension of the disclosure of certain tax return information for the administration of certain veterans programs. Part Fourteen is the Holocaust Restitution Tax Fairness Act of 2002 (Pub. L. No. 107–358). The Appendix provides the estimated budget effects of tax legislation enacted in the 107th Congress.

**PART ONE: THE FALLEN HERO SURVIVOR BENEFIT
FAIRNESS ACT OF 2001 (PUBLIC LAW 107-15) ²**

Present and Prior Law

The Taxpayer Relief Act of 1997 provided that an amount paid as a survivor annuity on account of the death of a public safety officer who is killed in the line of duty is excludable from income to the extent the survivor annuity is attributable to the officer's service as a law enforcement officer. The survivor annuity must be provided under a governmental plan to the surviving spouse (or former spouse) of the public safety officer or to a child of the officer. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. The provision does not apply with respect to the death of a public safety officer if it is determined by the appropriate supervising authority that (1) the death was caused by the intentional misconduct of the officer or by the officer's intention to bring about the death, (2) the officer was voluntarily intoxicated at the time of death, (3) the officer was performing his or her duties in a grossly negligent manner at the time of death, or (4) the actions of the individual to whom payment is to be made were a substantial contributing factor to the death of the officer.

The exclusion applies to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after that date.

Reasons for Change

The Congress believed that survivors of public safety officers killed in the line of duty should all receive the same tax treatment, regardless of when the officer died.

Explanation of Provision

The Act extends the exclusion of survivor annuities with respect to public safety officers killed in the line of duty with respect to individuals dying on or before December 31, 1996.

Effective Date

The provision is effective with respect to payments received after December 31, 2001.

²H.R. 1727. The House Committee on Ways and Means marked up the bill on May 9, 2001, and reported the bill, as amended, on May 15, 2001 (H.R. Rep. No. 107-65). The House passed the bill under a motion to suspend the rules and pass the bill on May 15, 2001. The Senate passed the bill by unanimous consent on May 22, 2001. The President signed the bill on June 5, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$4 million in 2002, \$5 million annually in 2003 through 2008, and \$4 million annually in 2009 through 2012.

**PART TWO: ECONOMIC GROWTH AND TAX RELIEF
RECONCILIATION ACT OF 2001 (PUBLIC LAW 107-16)³**

I. MARGINAL TAX RATE REDUCTION

**A. Individual Income Tax Rate Structure (sec. 101 of the Act
and sec. 1 of the Code)**

Present and Prior Law

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2001, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

³H.R. 1836; hereinafter referred to as "EGTRRA". EGTRRA passed the House on May 16, 2001. Provisions in H.R. 1836 were reported as separate legislation by the House Committee on Ways and Means and were passed by the House. These bills include H.R. 3 ("Economic Growth and Tax Relief Act of 2001") (H.R. Rep. 107-7), H.R. 6 ("Marriage Penalty and Family Tax Relief Act of 2001") (H.R. Rep. 107-29), H.R. 8 ("Death Tax Elimination Act of 2001") (H.R. Rep. 107-37), H.R. 10 ("Comprehensive Retirement Security and Pension Reform Act of 2001") (H.R. Rep. 107-51, Parts 1 and 2), and H.R. 622 ("Hope for Children Act") (H.R. Rep. 107-64).

The Senate Committee on Finance reported S. 896 ("Restoring Earnings to Lift Individuals and Empower Families (RELIEF) Act of 2001") on May 16, 2001 (S. Prt. 107-30). The Senate passed H.R. 1836, as amended with the provisions of S. 896, on May 23, 2001.

The conference report was filed on the bill on May 26, 2001 (H.R. Rep. No. 107-84), and was passed by the House and the Senate on May 26, 2001. The President signed the bill on June 7, 2001.

Table 1.—Individual Regular Income Tax Rates for 2001

If taxable income is over:	But not over:	Then regular income tax equals:
<i>Single individuals</i>		
\$0	\$27,050	15% of taxable income.
\$27,050	\$65,550	\$4,057.50, plus 28% of the amount over \$27,050.
\$65,550	\$136,750 ...	\$14,837.50, plus 31% of the amount over \$65,550.
\$136,750	\$297,350 ...	\$36,909.50, plus 36% of the amount over \$136,750.
Over \$297,350 .....	.....	\$94,725.50, plus 39.6% of the amount over \$297,350.
<i>Heads of households</i>		
\$0	\$36,250	15% of taxable income.
\$36,250	\$93,650	\$5,437.50, plus 28% of the amount over \$36,250.
\$93,650	\$151,650 ...	\$21,509.50, plus 31% of the amount over \$93,650.
\$151,650	\$297,350 ...	\$39,489.50, plus 36% of the amount over \$151,650.
Over \$297,350 .....	.....	\$91,941.50, plus 39.6% of the amount over \$297,350.
<i>Married individuals filing joint returns</i>		
\$0	\$45,200	15% of taxable income.
\$45,200	\$109,250 ...	\$6,780.00, plus 28% of the amount over \$45,200.
\$109,250	\$166,500 ...	\$24,714.50, plus 31% of the amount over \$109,250.
\$166,500	\$297,350 ...	\$42,461.50, plus 36% of the amount over \$166,500.
Over \$297,350 .....	.....	\$89,567.50, plus 39.6% of the amount over \$297,350.

Reasons for Change

The Congress believed that providing tax relief to the American people is appropriate for a number of reasons. The Congressional Budget Office (“CBO”) projected budget surpluses of \$5.6 trillion over the next 10 fiscal years (2001–2010). Federal revenues have been rising as a share of the gross domestic product (“GDP”). CBO projected that, during the fiscal year 2001–2010 period, Federal revenues will be more than 20 percent of the GDP annually. By contrast, during the early 1990’s, Federal revenues generally were only 17–18 percent of the GDP. Individual income taxes account for most of the recent rise in revenues as a percentage of GDP. Federal individual income tax revenues rose to over 10 percent of GDP in fiscal year 2000 for the first time in history and were projected by the CBO to exceed 10 percent of GDP for each of the fiscal years 2001–2010. The CBO projected that the growth of Federal revenues would, for fiscal year 2001, outstrip the growth of GDP for the

ninth consecutive year. Moreover, the CBO stated that “[t]he most significant source of the growth of income taxes relative to GDP was the increase in the effective tax rate.”⁴

The Federal income tax is intended to collect revenues to fund the programs of the Federal government. If more tax revenues are collected than are needed to fund the government, the Congress believed that at least a portion of the excess should be returned to the taxpayers who are paying Federal income taxes. A portion of the surplus could be returned while still retaining enough to pay down the public debt, fund priorities such as education and defense, and secure the future of Social Security and Medicare. Thus, the Congress believed that it was appropriate to provide relief from the high individual income tax rates of prior law. The Congress believed that this provision provides the appropriate level of tax relief without threatening funding for other national priorities. Finally, the Congress believed that the lower rates provided by this provision were a fair means to provide tax relief for all taxpayers.

The Congress believed that high marginal individual income tax rates reduce incentives for taxpayers to work, to save, and to invest and, thereby, have a negative effect on the long-term health of the economy. The higher that marginal tax rates are, the greater is the disincentive for individuals to increase their work effort. In addition, the Congress received testimony from tax experts that high marginal tax rates lead to reduced confidence in the Federal tax system and lower rates of voluntary compliance by taxpayers. Lower marginal tax rates provide greater incentives to taxpayers to be entrepreneurial risk takers; the Congress believed that the high marginal tax rates of prior law discourage success. EGTRRA provides tax relief to more than 100 million income tax returns of individuals, including at least 16 million returns of individuals who are owners of businesses (sole proprietorships, and S corporations). The Congress believed that this tax cut would lead to increased investment by these businesses, promoting long-term growth and stability in the economy and rewarding the businessmen and women who provide a foundation for our country’s success.

In addition, lower marginal tax rates help remove the barriers that lower-income families face as they try to enter the middle class. The lower the marginal tax rates for those taxpayers in the lowest income tax brackets, the greater is the incentive to work. The new 10-percent rate bracket in EGTRRA delivers more benefit as a percentage of income to low-income taxpayers than high-income taxpayers and provides an incentive for these taxpayers to increase their work effort.

EGTRRA provides immediate tax relief to American taxpayers in the form of a new rate bracket for the first \$6,000 of taxable income for single individuals and the first \$12,000 of taxable income for married couples filing a joint return. This new 10-percent rate bracket is effective this year. The Congress believed that such immediate tax relief may encourage short-term growth in the economy by providing individuals with additional cash to spend. Also, the new 10-percent rate bracket in the Act delivers more benefit as

⁴ Congressional Budget Office, Congress of the United States, *The Budget and Economic Outlook: Fiscal Years 2002–2011*, January 2001, at 56.

a percentage of income to low-income taxpayers than high-income taxpayers.

The Congress also believed that it is appropriate to repeal the 10-percent surtax imposed in 1993 to cut the deficit. This 10-percent surtax on top of the 36-percent rate resulted in a 39.6-percent marginal tax rate for those in the highest income tax bracket. Because the Congressional Budget Office was projecting budget surpluses over the next ten years, the Congress believed that it is appropriate to repeal this deficit-era surtax.

Finally, there were signs that the economy was slowing. The Congress believed that immediate tax relief could encourage short-term growth in the economy by providing individuals with additional cash to spend. However, the Congress recognized that it was important to act quickly so that taxpayers are aware of the commitment of the President and the Congress to enact this tax cut and to adjust income tax withholding tables. It was important that taxpayers immediately see the benefits of this tax relief in the form of more money in their pockets.

Explanation of Provision

In general

EGTRRA creates a new 10-percent regular income tax bracket for a portion of taxable income that is currently taxed at 15 percent, effective for taxable years beginning after December 31, 2000. EGTRRA also reduces the other regular income tax rates, effective July 1, 2001. By 2006, the present-law regular income tax rates (28 percent, 31 percent, 36 percent and 39.6 percent) will be lowered to 25 percent, 28 percent, 33 percent, and 35 percent, respectively.

New low-rate bracket

EGTRRA establishes a new 10-percent income tax rate bracket for a portion of taxable income that is currently taxed at 15 percent. The 10-percent rate bracket applies to the first \$6,000 of taxable income for single individuals, \$10,000 of taxable income for heads of households, and \$12,000 for married couples filing joint returns. This \$6,000 increases to \$7,000 and this \$12,000 increases to \$14,000 for 2008 and thereafter.

The taxable income levels for the new low-rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The new low-rate bracket for joint returns and head of household returns will be rounded down to the nearest \$50. The bracket for single individuals and married individuals filing separately will be one-half for joint returns (after adjustment of that bracket for inflation).

Rate reduction credit for 2001

EGTRRA includes a rate reduction credit for 2001 to more immediately achieve one of the purposes behind the new bottom rate bracket for 2001. The Congress chose to utilize this credit mechanism (and the issuance of checks described below) because it delivers economic stimulus to the economy more rapidly than would implementation of a new 10-percent rate bracket, even if that were accompanied by an immediate implementation of new wage with-

holding tables. Accordingly, this rate reduction credit operates in lieu of the new 10-percent income tax rate bracket for 2001.

This credit is computed in the following manner. Taxpayers are entitled to a credit in tax year 2001 of 5 percent (the difference between the 15-percent rate and the 10-percent rate) of the amount of income that would have been eligible for the new 10-percent rate. Taxpayers may not receive a credit in excess of their income tax liability (determined after nonrefundable credits).

Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury. The amount of the check is computed in the same manner as the credit, except that it will be done on the basis of tax returns filed for 2000 (instead of 2001). The Congress anticipated that the Department of the Treasury would make every effort to issue all checks before October 1, 2001, to taxpayers who timely filed their 2000 tax returns. Taxpayers who filed late or pursuant to extensions would receive their checks later in that fall.

Taxpayers would reconcile the amount of the credit with the check they receive in the following manner. They would complete a worksheet calculating the amount of the credit based on their 2001 tax return. They would then subtract from the credit the amount of the check they received. For many taxpayers, these two amounts would be the same. If, however, the result is a positive number (because, for example, the taxpayer paid no tax in 2000 but is paying tax in 2001), the taxpayer may claim that amount as a credit against 2001 tax liability. If, however, the result is negative (because, for example, the taxpayer paid tax in 2000 but owes no tax for 2001), the taxpayer is not required to repay that amount to the Treasury. Otherwise, the checks have no effect on tax returns filed in 2001; the amount is not includible in gross income and it does not otherwise reduce the amount of withholding. In no event may the Department of the Treasury issue checks after December 31, 2001.⁵ This is designed to prevent errors by taxpayers who might claim the full amount of the credit on their 2001 tax returns and file those returns early in 2002, at the same time the Treasury check might be mailed to them. Payment of the credit (or the check) is treated, for all purposes of the Code,⁶ as a payment of tax. As such, the credit or the check is subject to the refund offset provisions, such as those applicable to past-due child support under section 6402 of the Code.

In general, taxpayers eligible for the credit (and the check) are individuals other than estates or trusts, nonresident aliens, or dependents. The determination of this status for the relevant year is made on the basis of the information filed on the tax return.

The Congress understood that, in light of the large number of checks that would be issued, the issuance of checks would take several months.⁷ Accordingly, no interest will be paid with respect to these checks. Checks were to be issued in the order of the last two

⁵For administrative reasons, it was understood that the Department of the Treasury may need to establish an earlier termination date in order to fully implement the intent of this provision.

⁶A special rule provides that no interest will be paid with respect to the checks.

⁷The Congress investigated the possibility of utilizing electronic means, instead of paper checks, to deliver these amounts even more rapidly, but doing so was not possible because of limitations on available data on individual's banking accounts.

digits of the taxpayer identification number (which is generally a taxpayer's social security number), from lowest to highest. Payment by check is the only mechanism for receiving the payment prior to filing the 2001 tax return; taxpayers may not file either amended returns or claims for tentative refunds for tax year 2000 to claim these amounts.

It was anticipated that the IRS would send notices to most taxpayers approximately one month after enactment. The notices were to inform taxpayers of the computation of their checks and the approximate date by which they can expect to receive their check. This information was intended to decrease the number of telephone calls made by taxpayers to the IRS inquiring when their check will be issued.

Modification of 15-percent bracket

The 15-percent regular income tax bracket is modified to begin at the end of the new low-rate regular income tax bracket. The 15-percent regular income tax bracket ends at the same level as under present law. EGTRRA also makes other changes to the 15-percent rate bracket.⁸

Reduction of other rates and consolidation of rate brackets

The prior law regular income tax rates of 28 percent, 31 percent, 36 percent, and 39.6 percent are to be phased down over six years to 25 percent, 28 percent, 33 percent, and 35 percent, effective after June 30, 2001. Accordingly, for taxable years beginning during 2001, the rate reduction will come in the form of a blended tax rate. The taxable income levels for the new rates in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 2, below, shows the schedule of regular income tax rate reductions.

Table 2.—Regular Income Tax Rate Reductions

Calendar year	28% rate reduced to	31% rate reduced to	36% rate reduced to	39.6% rate reduced to
2001 ¹ –2003	27	30	35	38.6
2004–2005	26	29	34	37.6
2006 and later	25	28	33	35

¹Effective July 1, 2001.

Projected regular income tax rate schedules under EGTRRA

Table 3, below, shows the projected individual regular income tax rate schedules when the rate reductions are fully phased in (i.e., for 2006). As under present law, the rate brackets for married taxpayers filing separate returns under the bill are one half the rate brackets for married individuals filing joint returns. In addition, appropriate adjustments are made to the separate, compressed rate schedule for estates and trusts.

⁸See discussion of the provisions regarding marriage penalty relief in the 15-percent bracket, Part Two, Section III. A., of this document.

**Table 3.—Individual Regular Income Tax Rates for 2006
(Projected)**

If taxable income is:	But not over:	Then regular income tax equals:
<i>Single individuals</i>		
\$0	\$6,000	10 percent of taxable income.
\$6,000	\$30,950	\$600, plus 15% of the amount over \$6,000.
\$30,950	\$74,950	\$4,342.50, plus 25% of the amount over \$30,950.
\$74,950	\$156,300	\$15,342.50, plus 28% of the amount over \$74,950.
\$156,300	\$339,850	\$38,120.50, plus 33% of the amount over \$156,300.
Over \$339,850 .....	.....	\$98,692, plus 35% of the amount over \$339,850.
<i>Heads of households</i>		
\$0	\$10,000	10 percent of taxable income.
\$10,000	\$41,450	\$1,000, plus 15% of the amount over \$10,000.
\$41,450	\$107,000	\$5,717.50, plus 25% of the amount over \$41,450.
\$107,000	\$173,300	\$22,105, plus 28% of the amount over \$107,000.
\$173,300	\$339,850	\$40,669, plus 33% of the amount over \$173,300.
Over \$339,850 .....	.....	\$95,630.50, plus 35% of the amount over \$339,850.
<i>Married individuals filing joint returns</i>		
\$0	\$12,000	10 percent of taxable income.
\$12,000	\$57,850 ⁹	\$1,200, plus 15% of the amount over \$12,000.
\$57,850	\$124,900	\$8,077.50, plus 25% of the amount over \$57,850.
\$124,900	\$190,300	\$24,840, plus 28% of the amount over \$124,900.
\$190,300	\$339,850	\$43,152, plus 33% of the amount over \$190,300.
Over \$339,850 .....	.....	\$92,503.50, plus 35% of the amount over \$339,850.

Revised wage withholding for 2001

Under present and prior law, the Secretary of the Treasury is authorized to prescribe appropriate income tax withholding tables or computational procedures for the withholding of income taxes from wages paid by employers. The Secretary was expected to make appropriate revisions to the wage withholding tables to reflect the

⁹The end point of the 15-percent rate bracket for married individuals filing joint returns also reflects the phase-in of the increase in the size of the 15-percent bracket. See Part Two, Section III. B. of this document.

rate reduction effective beginning July 1, 2001, as expeditiously as possible.

Effective Date

The provisions of EGTRRA generally apply to taxable years beginning after December 31, 2000. The reductions in the tax rates, other than the new 10-percent rate, are effective after June 30, 2001. The conforming amendments to certain withholding provisions under EGTRRA are effective for amounts paid more than 60 days after the date of enactment.

Revenue Effect

The provisions to create a new 10 percent rate bracket and a credit with advanced payment in lieu of the new rate for 2001 are estimated to reduce Federal fiscal year budget receipts by \$38,186 million in 2001, \$33,421 million in 2002, \$40,223 million in 2003, \$40,336 million in 2004, \$40,201 million in 2005, \$40,203 million in 2006, \$40,065 million in 2007, \$43,422 million in 2008, \$45,359 million in 2009, \$46,034 million in 2010, and \$13,871 million in 2011.

The provision to reduce the other various income tax rates and brackets is estimated to reduce Federal fiscal year budget receipts by \$2,005 million in 2001, \$21,100 million in 2002, \$21,256 million in 2003, \$29,049 million in 2004, \$32,774 million in 2005, \$50,924 million in 2006, \$59,378 million in 2007, \$60,401 million in 2008, \$61,652 million in 2009, \$63,033 million in 2010, and \$19,035 million in 2011.

B. Phased-in Repeal of the Phase-Out of Itemized Deductions (sec. 102 of the Act and sec. 68 of the Code)

Present and Prior Law

Itemized deductions

Taxpayers may choose to claim either the basic standard deduction (and additional standard deductions, if applicable) or itemized deductions (subject to certain limitations) for certain expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Overall limitation on itemized deductions (“Pease” limitation)

Under present and prior law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer’s 2001 adjusted gross income in excess of \$132,950 (\$66,475 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present and prior law limitations applicable to such deductions

(such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under present and prior law, the otherwise allowable itemized deductions may not be reduced by more than 80 percent.

Reasons for Change

The Congress believed that the overall limitation on itemized deductions is an unnecessarily complex way to impose taxes and that the “hidden” way in which the limitation raises marginal tax rates undermines respect for the tax laws. The staff of the Joint Committee on Taxation recommended the elimination of certain phaseouts, including the overall limitation on itemized deductions, in a recent study containing recommendations for simplification of the Code.¹⁰ The overall limitation on itemized deductions requires a 10-line worksheet. Moreover, the first line of that worksheet requires the adding up of seven line items from Schedule A of the Form 1040, and the second line requires the adding up of four line items of Schedule A of the Form 1040. The Congress believed that reducing the application of the overall limitation on itemized deductions would significantly reduce complexity for affected taxpayers.

Explanation of Provision

EGTRRA repeals the overall limitation on itemized deductions for all taxpayers. The repeal is phased-in over five years, as follows. The otherwise applicable overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation is repealed for taxable years beginning after December 31, 2009.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$1,265 million in 2006, \$2,566 million in 2007, \$4,003 million in 2008, \$5,414 million in 2009, \$7,168 million in 2010, and \$4,456 million in 2011.

C. Phased-in Repeal of the Personal Exemption Phaseout (sec. 103 of the Act and sec. 151(d)(3) of the Code)

Present and Prior Law

In order to determine taxable income, an individual reduces adjusted gross income by any personal exemptions, deductions, and either the applicable standard deduction or itemized deductions.

¹⁰Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, Pursuant to section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01), April 2001.

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2001, the amount deductible for each personal exemption is \$2,900. This amount is adjusted annually for inflation.

Under present law, the deduction for personal exemptions is phased-out ratably for taxpayers with adjusted gross income over certain thresholds. The applicable thresholds for 2001 are \$132,950 for single individuals, \$199,450 for married individuals filing a joint return, \$166,200 for heads of households, and \$99,725 for married individuals filing separate returns. These thresholds are adjusted annually for inflation.

The total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each \$2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the applicable threshold. The phase-out rate is two percent for each \$1,250 for married taxpayers filing separate returns. Thus, the personal exemptions claimed are phased-out over a \$122,500 range (\$61,250 for married taxpayers filing separate returns), beginning at the applicable threshold. The size of these phase-out ranges (\$122,500/\$61,250) is not adjusted for inflation. For 2001, the point at which a taxpayer's personal exemptions are completely phased-out is \$255,450 for single individuals, \$321,950 for married individuals filing a joint return, \$288,700 for heads of households, and \$160,975 for married individuals filing separate returns.

Reasons for Change

The Congress believed that the personal exemption phase-out is an unnecessarily complex way to impose income taxes and that the "hidden" way in which the phase-out raises marginal tax rates undermines respect for the tax laws. The staff of the Joint Committee on Taxation recommended the elimination of certain phase-outs, including the personal exemption phase-out, in a recent study containing recommendations for simplification of the Code.¹¹ Furthermore, the Congress believed that the phase-out imposes excessively high effective marginal tax rates on families with children. The repeal of the personal exemption phase-out will restore the full exemption amount to all taxpayers and will simplify the tax laws.

Explanation of Provision

EGTRRA provides for a five-year phase-in of the repeal of the personal exemption phase-out. Under the five-year phase-in, the otherwise applicable personal exemption phase-out is reduced by one-third in taxable years beginning in 2006 and 2007, and is reduced by two-thirds in taxable years beginning in 2008 and 2009. The repeal is fully effective for taxable years beginning after December 31, 2009.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

¹¹*Id.*

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$473 million in 2006, \$955 million in 2007, \$1,382 million in 2008, \$1,793 million in 2009, \$2,216 million in 2010, and \$1,323 million in 2011.

II. TAX BENEFITS RELATING TO CHILDREN

A. Increase and Expand the Child Tax Credit (sec. 201 of the Act and sec. 24 of the Code)

Present and Prior Law

In general

Under present law, an individual may claim a \$500 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendant of either), stepson or stepdaughter, or eligible foster child.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (section 911); residents of Guam, American Samoa, and the Northern Mariana Islands (section 931); and residents of Puerto Rico (section 933)). The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between \$75,000 and \$85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between \$75,000 and \$95,000.

The child tax credit is not adjusted annually for inflation.

Refundability

In general, the child tax credit is nonrefundable. However, for families with three or more qualifying children, the child tax credit is refundable up to the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit.

Alternative minimum tax liability

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit and, for taxable years beginning after December 31, 2001, the amount of the refundable child credit for families with three or more children. This is known as the alternative minimum tax offset of refundable credits.

Through 2001, an individual generally may reduce his or her tentative alternative minimum tax liability by nonrefundable personal tax credits (such as the \$500 child tax credit and the adoption tax

credit). For taxable years beginning after December 31, 2001, non-refundable personal tax credits may not reduce an individual's income tax liability below his or her tentative alternative minimum tax.

Reasons for Change

The Congress believed that a tax credit for families with children recognizes the importance of helping families raise children. This provision doubles the child tax credit in order to provide additional tax relief to families to help offset the significant costs of raising a child. Further, the Congress believed that in order to extend some of the benefit of the child credit to families who currently do not benefit, the refundable child credit should be made available to families regardless of the number of children (rather than only families with three or more children). Additionally, the Congress believed that the child credit should be allowed to offset the alternative minimum tax. The provision also repeals the prior-law provision reducing the refundable child credit by the amount of the alternative minimum tax in order to ensure that no taxpayer will face an increase in net income tax liability as a result of the interaction of the alternative minimum tax with the regular income tax reductions in EGTRRA.

Explanation of Provision

In general

EGTRRA increases the child tax credit to \$1,000, phased-in over ten years, effective for taxable years beginning after December 31, 2000.

Table 4, below, shows the increase of the child tax credit.

Table 4.—Increase of the Child Tax Credit

Calendar year	Credit amount per child
2001–2004	\$600
2005–2008	\$700
2009	\$800
2010 and later	\$1,000

Refundability

EGTRRA makes the child credit refundable to the extent of 10 percent of the taxpayer's earned income in excess of \$10,000 for calendar years 2001–2004. The percentage is increased to 15 percent for calendar years 2005 and thereafter. The \$10,000 amount is indexed for inflation beginning in 2002. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the present and prior-law rule), if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of \$10,000. EGTRRA also provides that the refundable portion of the child credit does not constitute

income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Alternative minimum tax

EGTRRA provides that the refundable child credit will no longer be reduced by the amount of the alternative minimum tax. In addition, EGTRRA allows the child credit to the extent of the full amount of the individual's regular income tax and alternative minimum tax.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2000. The provision relating to allowing the child tax credit against alternative minimum tax is effective for taxable years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$518 million in 2001, \$9,291 million in 2002, \$9,927 million in 2003, \$10,602 million in 2004, \$12,786 million in 2005, \$18,320 million in 2006, \$19,000 million in 2007, \$19,408 million in 2008, \$20,532 million in 2009, \$25,200 million in 2010, and \$26,197 million in 2011.

B. Extension and Expansion of Adoption Tax Benefits (secs. 202 and 203 of the Act and secs. 23 and 137 of the Code)

Present and Prior Law

Tax credit

In general

A tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer. The maximum credit was \$5,000 per eligible child (\$6,000 for a special needs child) for taxable years beginning before January 1, 2002. An eligible child is an individual: (1) who has not attained age 18 or (2) is physically or mentally incapable of caring for himself or herself. A special needs child is an eligible child who is a citizen or resident of the United States whom a State has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of State or Federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child

of the taxpayer's spouse; and (4) not reimbursed (e.g., by an employer).

Under present and prior law, qualified adoption expenses may be incurred in one or more taxable years, but the prior law credit could not exceed \$5,000 per adoption (\$6,000 for a special needs child). The adoption credit is phased out ratably for taxpayers with modified adjusted gross income between \$75,000 and \$115,000 for taxable years beginning before January 1, 2002. Under present and prior law, modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively).

Under present and prior law, the adoption credit for special needs children is permanent. Under prior law, the adoption credit with respect to other children did not apply to expenses paid or incurred after December 31, 2001.

Alternative minimum tax

Under prior law through 2001, the adoption credit generally reduced the individual's regular income tax and alternative minimum tax. Under prior law, for taxable years beginning after December 31, 2001, the otherwise allowable adoption credit was allowed only to the extent that the individual's regular income tax liability exceeded the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit.

Exclusion from income

Under prior law, a maximum \$5,000 exclusion from the gross income of an employee was allowed for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. The maximum excludible amount was \$6,000 for special needs adoptions under prior law. Under prior law, the exclusion was phased out ratably for taxpayers with modified adjusted gross income between \$75,000 and \$115,000 for taxable years beginning before January 1, 2002. Under present and prior law, modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). Under present and prior law, for purposes of this exclusion, modified adjusted gross income also includes all employer payments and reimbursements for adoption expenses whether or not they are taxable to the employee. Under present and prior law, the exclusion does not apply for purposes of payroll taxes. Under present and prior law, adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. Under present and prior law, a taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

Under prior law, the exclusion from income did not apply to amounts paid or expenses incurred after December 31, 2001.

Reasons for Change

The Congress believed that the adoption credit and exclusion have been successful in reducing the after-tax cost of adoption to affected taxpayers. For this reason, the Congress believed that both these benefits should be extended permanently. The Congress noted that almost 50 percent of the tax returns filed in 1998 that received income tax benefits for adoption expenses reported total adoption expenses (including employer reimbursements) in excess of \$5,000. Further, approximately 25 percent of the tax returns filed in 1998 that received income tax benefits for adoption expenses reported total adoption expenses (including employer reimbursements) in excess of \$10,000. In the case of special needs adoptions, approximately 29 percent of the tax returns filed in 1998 that received income tax benefits for adoption expenses reported total adoption expenses (including employer reimbursements) in excess of \$6,000. The Congress believed that increasing the size of both the adoption credit and exclusion and expanding the number of taxpayers who qualify for the tax benefits will encourage more adoptions and allow more families to afford adoption. The Congress, however, was aware that families adopting special needs children may incur continuing expenses, after the adoption is finalized, that are not eligible for these tax benefits. The Congress will continue to search for ways to help alleviate these post-adoption expenses. Finally, the Congress believed that the alternative minimum tax should not be allowed to reduce the ability of adopting families to claim the adoption credit.

Explanation of Provision

Tax credit

EGTRRA makes the adoption credit permanent. The maximum credit is increased to \$10,000 per eligible child. The beginning point of the income phase-out range is increased to \$150,000 of modified adjusted gross income. Therefore, the adoption credit is phased-out for taxpayers with modified adjusted gross income of \$190,000 or more. Finally, the adoption credit is allowed against the alternative minimum tax.

EGTRRA also provides that for a special needs adoption finalized during a taxable year, the adoption expenses taken into account are increased by the excess, if any, of \$10,000 over the aggregate qualified adoption expenses with respect to the adoption for the taxable year the adoption becomes final and all prior taxable years.¹²

The dollar limits and income limitations of the adoption credit are adjusted for inflation in taxable years beginning after December 31, 2002.¹³

¹² A technical correction was enacted in section 411 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide this clarification.

¹³ A technical correction was enacted in section 418 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide uniform rounding rules (to the

Exclusion from income

EGTRRA makes the exclusion from income for employer-provided adoption assistance permanent. The maximum exclusion is increased to \$10,000 per eligible child. The beginning point of the income phase-out range is increased to \$150,000 of modified adjusted gross income. Therefore, the exclusion is not available to taxpayers with modified adjusted gross income of \$190,000 or more.

EGTRRA also provides that the adoption assistance in the case of a special needs adoption is increased by the excess, if any, of \$10,000 over the aggregate qualified adoption expenses with respect to the adoption for the taxable year the adoption becomes final and all prior taxable years.¹⁴

The dollar limits and income limitations of the employer-provided adoption assistance exclusion are adjusted for inflation in taxable years beginning after December 31, 2002.¹⁵

Effective Date

The provisions generally are effective for taxable years beginning after December 31, 2001. The provisions that allow the tax credit and exclusion from income for special needs adoptions regardless of whether the taxpayer has qualified adoption expenses are effective for taxable years beginning after December 31, 2002. Qualified expenses paid or incurred in taxable years beginning on or before December 31, 2001, remain subject to the prior-law dollar limits.¹⁶

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$51 million in 2002, \$191 million in 2003, \$252 million in 2004, \$293 million in 2005, \$325 million in 2006, \$349 million in 2007, \$375 million in 2008, \$403 million in 2009, \$432 million in 2010, \$464 million in 2011 and, \$222 million in 2012.

C. Expansion of Dependent Care Tax Credit (sec. 204 of the Act and sec. 21 of the Code)***Present and Prior Law******Dependent care tax credit***

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 30 percent of a limited amount of employment-related expenses. Under prior law, eligible employment-related expenses were limited to \$2,400 if there was one qualifying individual or \$4,800 if there were two or more qualifying individuals. Thus, the maximum credit was \$720 if there was one quali-

nearest multiple of \$10) for the inflation adjusted amounts in the adoption credit and employer-provided adoption assistance exclusion.

¹⁴ A technical correction was enacted in section 411 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide this clarification.

¹⁵ A technical correction was enacted in section 418 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide uniform rounding rules (to the nearest multiple of \$10) for the inflation adjusted amounts in the adoption credit and employer-provided adoption assistance exclusion.

¹⁶ A technical correction was enacted in section 411 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide this clarification.

fyng individual and \$1,440 if there were two or more qualifying individuals. The applicable dollar limit (\$2,400/\$4,800) of otherwise eligible employment-related expenses was reduced by any amount excluded from income under an employer-provided dependent care assistance program. For example, a taxpayer with one qualifying individual who had \$2,400 of otherwise eligible employment-related expenses but who excluded \$1,000 of dependent care assistance had to reduce the dollar limit of eligible employment-related expenses for the dependent care tax credit by the amount of the exclusion to \$1,400 ($\$2,400 - \$1,000 = \$1,400$).

Under present and prior law, a qualifying individual is (1) a dependent of the taxpayer under the age of 13 for whom the taxpayer is eligible to claim a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself, or (3) the spouse of the taxpayer; if the spouse is physically or mentally incapable of caring for himself or herself.

Under prior law, the 30 percent credit rate was reduced, but not below 20 percent, by 1 percentage point for each \$2,000 (or fraction thereof) of adjusted gross income above \$10,000. The credit was not available to married taxpayers unless they filed a joint return.

Exclusion for employer-provided dependent care

Under present and prior law, amounts paid or incurred by an employer for dependent care assistance provided to an employee generally are excluded from the employee's gross income and wages if the assistance is furnished under a program meeting certain requirements. These requirements include that the program be described in writing, satisfy certain nondiscrimination rules, and provide for notification to all eligible employees. Dependent care assistance expenses eligible for the exclusion are defined the same as employment-related expenses with respect to a qualifying individual under the dependent care tax credit.

Under prior law, the dependent care exclusion was limited to \$5,000 per year, except that a married taxpayer filing a separate return could exclude only \$2,500. Dependent care expenses excluded from income were not eligible for the dependent care tax credit (section 21(c)).

Explanation of Provision

EGTRRA increases the maximum amount of eligible employment-related expenses from \$2,400 to \$3,000, if there is one qualifying individual (from \$4,800 to \$6,000, if there are two or more qualifying individuals). EGTRRA also increases the maximum credit from 30 percent to 35 percent. Thus, the maximum credit is \$1,050, if there is one qualifying individual and \$2,100, if there are two or more qualifying individuals. Finally, EGTRRA modifies the phase-down of the credit. Under EGTRRA, the 35-percent credit rate is reduced, but not below 20 percent, by 1 percentage point for each \$2,000 (or fraction thereof) of adjusted gross income above \$15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with adjusted gross income over \$43,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$336 million in 2003, \$432 million in 2004, \$413 million in 2005, \$393 million in 2006, \$380 million in 2007, \$352 million in 2008, \$317 million in 2009, \$296 million in 2010, \$73 million in 2011, and less than \$500,000 in 2012.

**D. Tax Credit for Employer-Provided Child Care Facilities
(sec. 303 of the Act and new sec. 45D of the Code)*****Present and Prior Law***

Prior law did not provide a tax credit to employers for supporting child care or child care resource and referral services. Under present and prior law, an employer may be able to deduct such expenses as ordinary and necessary business expenses. Alternatively, the employer may be required to capitalize the expenses and claim depreciation deductions over time.

Explanation of Provision

Under EGTRRA, taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed \$150,000 per taxable year.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility;¹⁷ (2) for the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless: (1) it has open enrollment to the employees of the taxpayer; (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code; and (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is the principal trade or business of the taxpayer. Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care re-

¹⁷In addition, a depreciation deduction (or amortization in lieu of depreciation) must be allowable with respect to the property and the property must not be part of the principal residence of the taxpayer or any employee of the taxpayer.

source and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code.

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the ten-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax.¹⁸ Other rules apply.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$48 million in 2002, \$108 million in 2003, \$129 million in 2004, \$142 million in 2005, \$156 million in 2006, \$169 million in 2007, \$178 million in 2008, \$188 million in 2009, \$196 million in 2010, \$90 million in 2011 and, less than \$500,000 in 2012.

¹⁸A technical correction was enacted in section 411 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide this clarification.

III. MARRIAGE PENALTY RELIEF PROVISIONS

A. Standard Deduction Marriage Penalty Relief (sec. 301 of the Act and sec. 63 of the Code)

Present and Prior Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),¹⁹ which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2001, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns. Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

Reasons for Change

The Congress was concerned about the inequity that arises when two working single individuals marry and experience a tax increase solely by reason of their marriage. Any attempt to address the marriage tax penalty involves the balancing of several competing principles, including equal tax treatment of married couples with equal incomes, the determination of equitable relative tax burdens of single individuals and married couples with equal incomes, and the goal of simplicity in compliance and administration. The Congress believed that an increase in the standard deduction for married couples filing a joint return in conjunction with the other provi-

¹⁹ Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

sions of EGTRRA was a responsible reduction of the marriage tax penalty.

Explanation of Provision

EGTRRA increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same.

The increase in the standard deduction is phased-in over five years beginning in 2005 and would be fully phased-in for 2009 and thereafter. Table 5, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.²⁰

Table 5.—Phase-In of Increase of Standard Deduction for Married Couples Filing Joint Returns

Calendar year	Standard Deduction for Joint Returns as Percent- age of Standard Deduc- tion for Single Returns (percent)
2005	174
2006	184
2007	187
2008	190
2009 and later	200

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$685 million in 2005, \$1,954 million in 2006, \$2,580 million in 2007, \$2,772 million in 2008, \$3,164 million in 2009, \$2,932 million in 2010, and \$831 million in 2011.

²⁰ A technical correction was enacted in section 411 of the Job Creation and Worker Assistance Act of 2002 described in Part eight of this document to: (1) allow certain married taxpayers to file separate returns during the transition years; and (2) retain the rounding rules generally applicable to the amounts of standard deductions in section 63 of the Code.

B. Expansion of the 15-Percent Rate Bracket For Married Couples Filing Joint Returns (sec. 302 of the Act and sec. 1 of the Code)

Present and Prior Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.²¹ The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

Reasons for Change

The Congress believed that the expansion of the 15-percent rate bracket for married couples filing joint returns, in conjunction with the other provisions of EGTRRA, would alleviate the effects of the present-law marriage tax penalty. These provisions significantly reduce the most widely applicable marriage penalties in present and prior law.

Explanation of Provision

EGTRRA increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the

²¹The rate bracket breakpoint for the 39.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

size of the 15-percent regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 6, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 6.—Increase in Size of 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals (percent)
2005	180
2006	187
2007	193
2008 and thereafter	200

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$4,208 million in 2005, \$6,204 million in 2006, \$6,559 million in 2007, \$5,876 million in 2008, \$4,737 million in 2009, \$4,001 million in 2010, and \$1,150 million in 2011.

C. Marriage Penalty Relief and Simplification Relating to the Earned Income Credit (sec. 303 of the Act and sec. 32 of the Code)

Present and Prior Law

In general

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit an eligible taxpayer may claim depends upon the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children.

Under present and prior law, the earned income credit was not available to married individuals who filed separate returns. Under present and prior law, no earned income credit is allowed if the taxpayer has disqualified income in excess of \$2,450 (for 2001) for the taxable year.²² In addition, under present and prior law, no

²² Section 32(i). Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt income received or accrued in the taxable year; (3) net income from rents and royalties for the taxable year not derived in the ordinary course of business; (4) capital gain net income of the taxpayer for the taxable year; and (5) net passive income for the taxable year. Sec. 32(i)(2).

earned income credit is allowed if an eligible individual is the qualifying child of another taxpayer.²³

Definition of qualifying child and tie-breaker rules

To claim the earned income credit, a taxpayer must either: (1) have a qualifying child or (2) meet the requirements for childless adults. Under present and prior law, a qualifying child must meet a relationship test, an age test, and a residence test. Under prior law, the qualifying child must have been the taxpayer's child, step-child, adopted child, grandchild, or foster child. Under present and prior law, the child must be under age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. The child must live with the taxpayer in the United States for more than half the year (under prior law, a full year for foster children).

Under prior law, an individual satisfied the relationship test under the earned income credit if the individual was the taxpayer's: (1) son or daughter or a descendant of either;²⁴ (2) stepson or stepdaughter; or (3) eligible foster child. Under prior law, an eligible foster child was an individual: (1) who was a brother, sister, stepbrother, or stepsister of the taxpayer (or a descendant of any such relative), or who was placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cared for as her or his own child. Under present and prior law, a married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.²⁵

Under prior law, if a child otherwise qualified with respect to more than one person, the child was treated as a qualifying child only of the person with the highest modified adjusted gross income.

Under prior law, "modified adjusted gross income" meant adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income.²⁶ The losses disregarded were: (1) net capital losses (up to \$3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; and (4) 75 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses. The amounts added to adjusted gross income to arrive at modified adjusted gross income included: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers).

Definition of earned income

To claim the earned income credit, the taxpayer must have earned income. Under present and prior law, earned income con-

²³ Section 32(c)(1)(B).

²⁴ A child who was legally adopted or placed with the taxpayer for adoption by an authorized adoption agency was treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

²⁵ Section 32(c)(3)(B)(ii).

²⁶ Section 32(c)(5).

sists of wages, salaries, other employee compensation, and net earnings from self employment.²⁷ Under prior law, employee compensation included anything of value received by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income under prior law included the following: (1) elective deferrals under a cash or deferred arrangement or section 403(b) annuity (section 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance (section 106), dependent care (section 129), adoption assistance (section 137), educational assistance (section 127), and miscellaneous fringe benefits (section 132); (3) salary reduction contributions under a cafeteria plan (section 125); (4) meals and lodging provided for the convenience of the employer (section 119); and (5) housing allowance or rental value of a parsonage for the clergy (section 107).²⁸ Some of these items are not required to be reported on the Wage and Tax Statement (Form W-2).

Calculation of the credit

The maximum earned income credit is phased in as an individual's earned income increases. The credit phases out for individuals with earned income (or, under prior law, modified adjusted gross income, if greater) over certain levels. Under present and prior law, in the case of a married individual who had filed a joint return, the earned income credit both for the phase-in and phase-out was calculated based on the couple's combined income.

The credit is determined by multiplying the credit rate by the taxpayer's earned income up to a specified earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) under prior law, modified adjusted gross income (or earnings, if greater) at or below the phase-out threshold level.

Under prior law, for taxpayers with modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount was reduced by the phase-out rate multiplied by the amount of earned income (or modified adjusted gross income, if greater) in excess of the phase-out threshold. In other words, the credit amount was reduced, falling to \$0 at the "breakeven" income level, the point where a specified percentage of "excess" income above the phase-out threshold offset exactly the maximum amount of the credit. Under present and prior law, the earned income amount and the phase-out threshold are adjusted annually for inflation. Table 7, below, shows the earned income credit parameters for taxable year 2001.²⁹

²⁷ Section 32(c)(2)(A).

²⁸ The excludable amount of clergy housing allowances was modified by the Clergy Housing Allowance Clarification Act of 2002, described in Part Nine of this document.

²⁹ The table is based on Rev. Proc. 2001-13.

Table 7.—Earned Income Credit Parameters (2001)

	Two or more qualifying children	One quali- fying child	No quali- fying chil- dren
Credit rate (percent)	40.00%	34.00%	7.65%
Earned income amount ..	\$10,020	\$7,140	\$4,760
Maximum credit	\$4,008	\$2,428	\$364
Phase-out begins	\$13,090	\$13,090	\$5,950
Phase-out rate (percent)	21.06%	15.98%	7.65%
Phase-out ends	\$32,121	\$28,281	\$10,710

Under prior law, an individual's alternative minimum tax liability reduced the amount of the refundable earned income credit.³⁰

Reasons for Change

The Congress believed that the prior-law earned income amount penalized some individuals because they received a smaller earned income credit if they were married than if they were not married. The Congress believed increasing the phase-out amount for married taxpayers who filed a joint return would help to alleviate this penalty.

EGTRRA repeals the prior-law provision reducing the earned income credit by the amount of the alternative minimum tax. EGTRRA ensures that no taxpayer will face an increase in net income tax liability as a result of the interaction of the alternative minimum tax with the regular income tax reductions in the bill.

The Congress believed that providing tax relief to Americans was a top priority. In addition, the Congress believed that simplification of our tax laws was important to alleviate the burdens on American taxpayers. As required by the IRS Restructuring and Reform Act of 1998, the staff of the Joint Committee on Taxation released a simplification study.³¹ The study contains recommendations for simplification reaching all areas of the Federal tax laws. As a first step toward simplification, the Congress believed it should consider simplification to the extent possible in the context of fulfilling the priority of providing needed tax relief. Thus, the Congress adopted three of the proposals recommended by the Joint Committee staff relating to the earned income credit: (1) the definition of earned income, (2) replacement of the prior-law tie-breaker rules, and (3) uniformity in the definition of a qualifying child.

The definition of earned income was a source of complexity insofar as it included nontaxable forms of employee compensation. Prior law required both the IRS and taxpayers to keep track of nontaxable amounts for determining earned income credit eligibility even though such amounts are generally not necessary for other tax purposes. Further, not all forms of nontaxable earned income are reported on Form W-2. As a result, a taxpayer may not know the correct amount of nontaxable earned income received

³⁰ Section 32(h).

³¹ Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

during the year. Further, the IRS cannot easily determine such amounts. The Congress believed that significant simplification would result from redefining earned income to exclude amounts not includable in gross income.

The prior-law tie-breaker rules also resulted in significant complexity. When a qualifying child lived with more than one adult who appeared to qualify to claim the child for earned income credit purposes, under prior law, the adult with the highest modified adjusted gross income was to claim the child. In a recent study, the IRS found that the second largest amount of errors, 17.1 percent of overclaims, was attributable to the person with the lower modified adjusted gross income claiming the child.³² The Congress believed it was appropriate to replace the prior-law tie-breaker rules with a more simplified rule that applies only in the case of competing claims.

The Congress applied the definition of qualifying child recommended by the staff of the Joint Committee for purposes of the earned income credit as a first step toward broader simplification efforts. The Congress believed that the distinctions among familial relationships drawn by prior law in defining a qualifying child added to the complexity of the earned income credit. For example, a taxpayer's son or daughter was a qualifying child if he or she had lived with the taxpayer for more than six months, while the taxpayer's niece or nephew was required to have lived with the taxpayer for the entire year, even though the taxpayer cared for the child as his or her own. In addition, foster children must have resided with the taxpayer for the entire year as opposed to the general rule of six months. The Congress believed that applying a uniform rule that requires any qualifying child to reside with the taxpayer for more than six months would alleviate some of the complexity in this area.

The National Taxpayer Advocate recommended the elimination of the use of modified adjusted gross income as a means to simplify the earned income credit.³³ The Congress believed that replacing modified adjusted gross income with adjusted gross income would reduce the number of calculations required, thereby simplifying the credit.

The IRS reported that more than a quarter of earned income credit claims in 1997, \$7.8 billion, were paid erroneously.³⁴ The IRS found that the most common error involved taxpayers claiming children who did not meet the eligibility criteria. The IRS attributed most of these errors to taxpayers claiming the earned income credit for children who do not meet the residency requirement.³⁵ Recently, the IRS began receiving data from the Department of Health and Human Services' Federal Case Registry of Child Support Orders, a Federal database containing state information on child support payments. This data assists the IRS in identifying erroneous earned income credit claims by noncustodial parents. The

³² Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (September 2000), at 10.

³³ Internal Revenue Service, *National Taxpayer Advocate's FY2000 Annual Report to Congress*, Publication 2104 (December 2000) at 74.

³⁴ Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (September 2000), at 3.

³⁵ *Id.* at 10.

Congress believed that giving the IRS authority to deny questionable claims filed by noncustodial parents would reduce the erroneous filing and payment of earned income credit claims. The Congress, however, desired further information regarding the accuracy of the Federal Case Registry of Child Support Orders, its usefulness to the IRS in detecting erroneous or fraudulent claims, and the appropriateness of using math error procedures based on this data.

Explanation of Provision

For married taxpayers who file a joint return, EGTRRA increases the beginning and ending of the earned income credit phase-out as follows: by \$1,000 in the case of taxable years beginning in 2002, 2003, and 2004; by \$2,000 in the case of taxable years beginning in 2005, 2006, and 2007; and by \$3,000 in the case of taxable years beginning after 2007. The \$3,000 amount is to be adjusted annually for inflation after 2008.

EGTRRA simplifies the definition of earned income by excluding nontaxable employee compensation from the definition of earned income for earned income credit purposes. Thus, under EGTRRA, earned income includes wages, salaries, tips, and other employee compensation, if includible in gross income for the taxable year, plus net earnings from self employment.

EGTRRA repeals the prior-law provision that reduces the earned income credit by the amount of an individual's alternative minimum tax.

EGTRRA simplifies the calculation of the earned income credit by replacing modified adjusted gross income with adjusted gross income.

EGTRRA provides that the relationship test is met if the individual is the taxpayer's son, daughter, stepson, stepdaughter, or a descendant of any such individuals.³⁶ A brother, sister, stepbrother, stepsister, or a descendant of such individuals, also qualifies if the taxpayer cares for such individual as his or her own child. A foster child satisfies the relationship test as well. A foster child is defined as an individual who is placed with the taxpayer by an authorized placement agency and who the taxpayer cares for as his or her own child. In order to be a qualifying child, in all cases the child must have the same principal place of abode as the taxpayer for over one-half of the taxable year.

EGTRRA changes the prior-law tie-breaking rule. Under the provision, if an individual would be a qualifying child with respect to more than one taxpayer, and more than one taxpayer claims the earned income credit with respect to that child, then the following tie-breaking rules apply. First, if one of the individuals claiming the child is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return together, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year, and second of the parent with the highest adjusted gross income. Finally, if none of the tax-

³⁶ As under prior law, an adopted child is treated as a child of the taxpayer by blood.

payers claiming the child as a qualifying child is the child's parent, the child is considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

EGTRRA authorizes the IRS, beginning in 2004, to use math error authority to deny the earned income credit if the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed.

It was the intent of Congress that by September 2002, the Department of the Treasury, in consultation with the National Taxpayer Advocate, deliver to the Senate Committee on Finance and the House Committee on Ways and Means a study of the Federal Case Registry database. The study was to cover (1) the accuracy and timeliness of the data in the Federal Case Registry, (2) the efficacy of using math error authority in this instance in reducing costs due to erroneous or fraudulent claims, and (3) the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data.

The Congress realized that the expansion of the earned income credit may create a financial hardship on U.S. possessions with mirror codes and that further study of such effects is necessary.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2001. The provision to authorize the IRS to use math error authority if the Federal Case Registry of Child Support Orders indicates the taxpayer is the noncustodial parent is effective beginning in 2004.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$8 million in 2002, \$847 million in 2003, \$1,277 million in 2004, \$1,243 million in 2005, \$1,817 million in 2006, \$1,819 million in 2007, \$1,787 million in 2008, \$2,258 million in 2009, \$2,240 million in 2010, \$2,348 million in 2011 and, less than \$500,000 in 2012.

IV. AFFORDABLE EDUCATION PROVISIONS

A. Education Individual Retirement Accounts (sec. 401 of the Act and sec. 530 of the Code)³⁷

Present and Prior Law

In general

Section 530 of the Code provides tax-exempt status to education individual retirement accounts (“education IRAs”), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash.³⁸ Annual contributions to education IRAs may not exceed \$500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18.

Phase-out of contribution limit

The \$500 annual contribution limit for education IRAs is generally phased-out ratably for contributors with modified adjusted gross income between \$95,000 and \$110,000. The phase-out range for married taxpayers filing a joint return is \$150,000 to \$160,000 of modified adjusted gross income. Individuals with modified adjusted gross income above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

Treatment of distributions

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the beneficiary to the extent that the total distribution does not exceed the “qualified higher education expenses” incurred by the beneficiary during the year the distribution is made.

If the qualified higher education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total

³⁷ Education individual retirement accounts are now referred to as Coverdell education savings accounts pursuant to Pub. L. No. 107-22 described in Part Three of this document.

³⁸ Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10-percent tax. The 10-percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, on account of a scholarship received by the designated beneficiary, or if the distribution is included in income solely because the HOPE (or Lifetime Learning) credit is claimed for those expenses.

Under prior law the additional 10-percent tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present and prior law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

Qualified higher education expenses

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA.

Moreover, qualified higher education expenses include, within limits, room and board expenses for any academic period during which the beneficiary is at least a half-time student. Room and board expenses that may be treated as qualified higher education expenses are limited to the minimum room and board allowance applicable to the student in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment of the Small Business Job Protection Act of 1996 (August 20, 1996). Thus, room and board expenses cannot exceed the following amounts: (1) for a student living at home with parents or guardians, \$1,500 per academic year; (2) for a student living in housing owned or operated by the eligible education institution, the institution's "normal"

room and board charge; and (3) for all other students, \$2,500 per academic year.

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

Present and prior law also provides that if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Time for making contributions

Contributions to an education IRA for a taxable year are taken into account in the taxable year in which they are made.

Coordination with HOPE and Lifetime Learning credits

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

Coordination with qualified tuition programs

An excise tax is imposed on contributions to an education IRA for a year if contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary in the same year. The excise tax is equal to 6 percent of the contributions to the education IRA. The excise tax is imposed each year after the contribution is made, unless the contributions are withdrawn.

Reasons for Change

Education IRAs were intended to help families plan for their children's education. However, the Congress believed that the prior-law limits on contributions to education IRAs do not permit

taxpayers to save adequately. Therefore, EGTRRA increased the contribution limits to education IRAs.

The Congress believed that education IRAs should be expanded to provide greater flexibility to families in providing for their children's education at all levels of education. Thus, EGTRRA allows education IRAs to be used for certain expenses related to elementary and secondary education.

The Congress believed that other modifications would also improve the attractiveness and operation of education IRAs, thus improving the effectiveness of education IRAs in assisting families in paying for education. Such modifications included more flexible rules for education IRAs for special needs beneficiaries and relaxation of the rules restricting the use of education IRAs and other tax benefits for education in the same year.

Explanation of Provision

Annual contribution limit

EGTRRA increases the annual limit on contributions to education IRAs from \$500 to \$2,000. Thus, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary is limited to \$2,000 for each year.

Qualified education expenses

EGTRRA expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include "qualified elementary and secondary school expenses," meaning expenses for: (1) tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law, (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

Phase-out of contribution limit

EGTRRA increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is \$190,000 to \$220,000 of modified adjusted gross income.

Special needs beneficiaries

EGTRRA provides that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30. Finally, the age 30 limitation does not apply in the case of a rollover contribution for the benefit of a special needs beneficiary or a change in beneficiaries to a special needs beneficiary. The Congress intends that Treasury regulations will define a special needs beneficiary to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

Contributions by persons other than individuals

EGTRRA clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

Contributions permitted until April 15

Under EGTRRA, individual contributors to education IRAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally may make contributions for a year until April 15 of the following year.

Qualified room and board expenses

EGTRRA modifies the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs, section 402 of EGTRRA, below.

Coordination with HOPE and Lifetime Learning credits

EGTRRA allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed. As under prior law, a taxpayer could still use funds from an education IRA to pay for the same expenses for which a HOPE (or Lifetime Learning) credit was claimed. The earnings on the education IRA would be includable in income, but no 10-percent penalty tax would be due.³⁹

³⁹A technical correction was enacted in Section 411 of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document to provide this clarification.

Coordination with qualified tuition programs

EGTRRA repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

If distributions from education IRAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the amount includible in income.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$203 million in 2002, \$365 million in 2003, \$461 million in 2004, \$561 million in 2005, \$667 million in 2006, \$778 million in 2007, \$892 million in 2008, \$1,013 million in 2009, \$1,136 million in 2010, and \$295 million in 2011.

B. Private Prepaid Tuition Programs; Exclusion From Gross Income of Education Distributions From Qualified Tuition Programs (sec. 402 of the Act and sec. 529 of the Code)***Present and Prior Law***

Section 529 of the Code provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above in Section 401 of EGTRRA) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution,⁴⁰ as well as certain room and board expenses for any period during which the student is at least a half-time student.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that: (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless

⁴⁰ An "eligible education institution" is defined the same for purposes of education IRAs (described in Section 401 of EGTRRA above) and qualified State tuition programs.

excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.⁴¹

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.⁴² Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family and the transfer is completed within 60 days. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)–(9).

Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is: (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in section 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satis-

⁴¹ Distributions from qualified State tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

⁴² Special estate and gift tax rules apply to contributions made to and distributions made from qualified State tuition programs.

fied and the modified AGI phase-out for those credits does not apply).

Reasons for Change

The Congress believed that distributions from qualified State tuition programs should not be subject to Federal income tax to the extent that such distributions are used to pay for qualified higher education expenses of undergraduate or graduate students who are attending college, university, or certain vocational schools. In addition, the Congress believed that the prior-law rules governing qualified tuition programs should be expanded to permit private educational institutions to maintain certain prepaid tuition programs. The Congress believed that the amount of room and board expenses that can be paid with tax-free distributions from qualified tuition programs should reflect current costs.

Explanation of Provision

Qualified tuition programs

EGTRRA expands the definition of “qualified tuition program” to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the otherwise applicable State sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but are not able to make contributions to a savings account plan (as described in section 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements. Additionally, in order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under section 408(a)(2) and (5) of the Code. Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

Exclusion from gross income

Under EGTRRA, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a State (or agency or instrumentality thereof) for distributions made in taxable years beginning after December 31, 2003.

Qualified higher education expenses

EGTRRA provides that, for purposes of the exclusion for distributions from qualified tuition programs, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board.⁴³

EGTRRA modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution.⁴⁴ A special needs beneficiary is defined as under the provisions relating to education IRAs, described above in section 401 of EGTRRA.

Coordination with HOPE and Lifetime Learning credits

EGTRRA allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same qualified expenses for which a credit was claimed.

Rollovers for benefit of same beneficiary

EGTRRA provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution, provided the transfer is made within 60 days of the distribution from the initial program. This rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. The Congress intends that this provision will allow, for example, transfers between a prepaid tuition program and a savings program maintained by the same State and between a State program and a private prepaid tuition program.

Member of family

EGTRRA provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes first cousins of the original beneficiary.

Penalty for withdrawals not used for qualified education expenses

EGTRRA repeals the prior-law rule that a qualified State tuition program must impose a more than de minimis monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, EGTRRA imposes an additional 10-percent tax on the amount of a distribution from a qualified tuition program that is

⁴³This definition also applies to distributions from education IRAs.

⁴⁴This definition also applies to distributions from education IRAs.

includible in gross income (like the additional tax that applies to such distributions from education IRAs). The same exceptions that apply to the 10-percent additional tax with respect to education IRAs apply. A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule, the additional 10-percent tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives.⁴⁵ For example, under EGTRRA, a taxpayer who receives distributions from an education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. The Congress expects that the Secretary will exercise the existing authority under sections 529(d) and 530(h) to require appropriate reporting, e.g., of the amount of distributions and the earnings portions of distributions (taxable and nontaxable), to facilitate the provisions.

Effective Date

The provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a State (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$24 million in 2002, \$53 million in 2003, \$81 million in 2004, \$111 million in 2005, \$141 million in 2006, \$170 million in 2007, \$200 million in 2008, \$234 million in 2009, \$256 million in 2010, and \$64 million in 2011.

⁴⁵The Congress also believed that this change was appropriate in light of the expansion of qualified tuition programs to include programs maintained by private institutions.

**C. Exclusion for Employer-Provided Educational Assistance
(sec. 411 of the Act and sec. 127 of the Code)**

Present and Prior Law

Educational expenses paid by an employer for its employees are generally deductible by the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a Code section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under Code section 132. Code section 127 provides an exclusion of \$5,250 annually for employer-provided educational assistance. The exclusion did not apply to graduate courses beginning after June 30, 1996. Under prior law the exclusion for employer-provided educational assistance for undergraduate courses would have expired with respect to courses beginning after December 31, 2001.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than five percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the Code section 127 exclusion may be excludable from income as a working condition fringe benefit.⁴⁶ In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under Code section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under Code section 162 if the education: (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.⁴⁷

Reasons for Change

The Congress believed that the exclusion for employer-provided educational assistance has enabled millions of workers to advance their education and improve their job skills without incurring additional taxes and a reduction in take-home pay. In addition, the exclusion lessens the complexity of the tax laws. Without the special

⁴⁶ These rules also apply in the event that Code section 127 expires.

⁴⁷ In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous expenses, exceed two percent of the taxpayer's AGI. An individual's total deductions may also be reduced by the overall limitation on itemized deductions under Code section 68. These limitations do not apply in determining whether an item is excludable from income as a working condition fringe benefit.

exclusion, a worker receiving educational assistance from his or her employer is subject to tax on the assistance, unless the education is related to the worker's current job. Because the determination of whether particular educational assistance is job related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.

The Congress believed that reinstating the exclusion for graduate-level employer-provided educational assistance will enable more individuals to seek higher education, and that further extension of the exclusion is important.

The past experience of allowing the exclusion to expire and later extending it retroactively has created burdens for employers and employees. Employees may have difficulty planning for their educational goals if they do not know whether their tax bills will increase. For employers, the lack of permanence of the provision has caused severe administrative problems. Uncertainty about the exclusion's future may discourage some employers from providing educational benefits.

Explanation of Provision

EGTRRA extends the exclusion for employer-provided educational assistance to graduate education and makes the exclusion (as applied to both undergraduate and graduate education) permanent.

Effective Date

The provision is effective with respect to courses beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$519 million in 2002, \$720 million in 2003, \$760 million in 2004, \$804 million in 2005, \$852 million in 2006, \$904 million in 2007, \$958 million in 2008, \$1,012 million in 2009, \$1,068 million in 2010, and \$267 million in 2011.

D. Modifications to Student Loan Interest Deduction (sec. 412 of the Act and sec. 221 of the Code)

Present and Prior Law

Certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. Under prior law the deduction was allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally did not include voluntary payments, such as interest payments made during a period of loan forbearance under prior law. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is

claimed as a dependent on another taxpayer's return for the taxable year.

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

The maximum allowable annual deduction was \$2,500 under prior law. Under prior law the deduction was phased-out ratably for single taxpayers with modified adjusted gross income between \$40,000 and \$55,000 and for married taxpayers filing joint returns with modified adjusted gross income between \$60,000 and \$75,000. The income ranges will be adjusted for inflation after 2002.

Reasons for Change

The Congress believed that it was appropriate to expand the deduction for individuals who pay interest on qualified education loans by repealing the limitation that the deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. In addition, the repeal of the 60-month limitation lessens complexity and administrative burdens for taxpayers, lenders, loan servicing agencies, and the Internal Revenue Service. The Congress also believed it appropriate to increase the income phase-out ranges applicable to the student loan interest deduction to make the deduction available to more taxpayers and to reduce the potential marriage penalty caused by the phase-out ranges.

Explanation of Provision

EGTRRA increases the income phase-out ranges for eligibility for the student loan interest deduction to \$50,000 to \$65,000 for single taxpayers and to \$100,000 to \$130,000 for married taxpayers filing joint returns. These income phase-out ranges are adjusted annually for inflation after 2002.

EGTRRA repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

Effective Date

The provision is effective for interest paid on qualified education loans after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$170 million in 2002, \$245 million in 2003, \$262 million

in 2004, \$277 million in 2005, \$289 million in 2006, \$305 million in 2007, \$321 million in 2008, \$338 million in 2009, \$356 million in 2010, and \$89 million in 2011.

E. Eliminate Tax on Awards Under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (sec. 413 of the Act and sec. 117 of the Code)

Present and Prior Law

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

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

The National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”) provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Reasons for Change

The Congress believed it was appropriate to provide tax-free treatment for scholarships received by medical, dental, nursing, and physician assistant students under the NHSC Scholarship Program and the Armed Forces Scholarship Program.

Explanation of Provision

EGTRRA provides that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under Code section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under Code section 117, the tax-free treatment does not apply to amounts received by students for regular living expenses, including room and board.

Effective Date

The provision is effective for education awards received after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$1 million annually in 2002–2010, and less than \$500,000 million in 2011.

F. Liberalization of Tax-Exempt Financing Rules for Public School Construction (secs. 421–422 of the Act and secs. 142 and 146–148 of the Code)

Present and Prior Law

Tax-exempt bonds

In general

Interest on debt⁴⁸ incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (section 103).⁴⁹ Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called “private activity bonds.”⁵⁰ The term “private person” includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present and prior law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt

⁴⁸ Hereinafter referred to as “State or local government bonds.”

⁴⁹ Interest on this debt is included in calculating the “adjusted current earnings” preference of the corporate alternative minimum tax.

⁵⁰ Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code—including elementary, secondary, and post-secondary schools—may be financed with tax-exempt private activity bonds (“qualified 501(c)(3) bonds”).

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

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

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2002, these annual volume limits were equal to the greater of \$75 per resident of the State or \$225 million. After 2002, the volume limits will be indexed annually for inflation.

Arbitrage restrictions on tax-exempt bonds

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

Present and prior law includes three exceptions to the arbitrage rebate requirements applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate

arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.⁵¹

Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.⁵² Issuers qualifying for this “construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$10 million if at least \$5 million of the bonds are used to finance public schools.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds.” Under present and prior law, a total of \$400 million of qualified zone academy bonds may be issued in each of 1998 through 2003.⁵³ The \$400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

⁵¹In the case of governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

⁵²Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued.

⁵³The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147, March 9, 2002) extended qualified zone academy bonds as modified by this provision for two additional years (i.e., 2002 and 2003), described in Part Eight of this document.

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

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

Reasons for Change

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. The exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which typically require voter approval before issuance. The Congress believed that a limited increase of \$5 million per year for public school construction bonds will more accurately conform this prior-law exception to current school construction costs.

Further, the Congress wished to encourage public-private partnerships to improve educational opportunities. To permit public-private partnerships to reap the benefit of the implicit subsidy to capital costs provided through tax-exempt financing, the Congress determined that it is appropriate to allow the issuance of tax-exempt private activity bonds for public school facilities.

Explanation of Provision

Increase amount of governmental bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from \$5 million to \$10 million. Thus, these governmental units may issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds are used to finance public school construction expenditures.

Allow issuance of tax-exempt private activity bonds for public school facilities

The private activities for which tax-exempt bonds may be issued are expanded to include elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. For this purpose, ownership is determined based on the holding of legal title to facilities, without regard to tax ownership. The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events)⁵⁴ and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-State private activity bond volume limit equal to \$10 per resident (\$5 million, if greater) in lieu of the present and prior-law State private activity bond volume limits. As with the present and prior-law State private activity bond volume limits, States can decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present and prior-law private activity bond volume limits.

Effective Date

The provisions are effective for bonds issued after December 31, 2001.

Revenue Effect

The provision to increase the arbitrage rebate exception for governmental bonds used to finance qualified school construction is estimated to reduce Federal fiscal year budget receipts by less than \$500,000 in 2002, \$3 million in 2003, \$5 million in 2004, \$6 million in 2005, \$11 million in 2006, \$15 million in 2007, \$16 million in 2008, \$17 million in 2009, \$18 million in 2010, \$19 million in 2011 and, \$17 million in 2012.

The provision to issue tax-exempt private activity bonds for qualified educational facilities is estimated to reduce Federal fiscal year budget receipts by \$5 million in 2002, \$19 million in 2003, \$38 million in 2004, \$61 million in 2005, \$88 million in 2006, \$120 mil-

⁵⁴The present and prior-law limit on the amount of the proceeds of a private activity bond issue that may be used to finance land acquisition does not apply to these bonds.

lion in 2007, \$155 million in 2008, \$191 million in 2009, \$227 million in 2010, \$251 million in 2011 and \$249 million in 2012.

G. Deduction for Qualified Higher Education Expenses (sec. 431 of the Act and new sec. 222 of the Code)

Present and Prior Law

Deduction for education expenses

Under present and prior law, an individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under Code section 162 if the education or training: (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. section 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above described criteria for deductibility under Code section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income.

HOPE and Lifetime Learning credits

HOPE credit

Under present and prior law, individual taxpayers are allowed to claim a nonrefundable credit, the "HOPE" credit, against Federal income taxes of up to \$1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post secondary education in a degree or certificate program. The HOPE credit rate is 100 percent on the first \$1,000 of qualified tuition and related expenses, and 50 percent on the next \$1,000 of qualified tuition and related expenses.⁵⁵ The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.⁵⁶ The HOPE credit that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). For taxable years beginning after 2001, the \$1,500 max-

⁵⁵ Thus, an eligible student who incurs \$1,000 of qualified tuition and related expenses is eligible (subject to the AGI phase-out) for a \$1,000 HOPE credit. If an eligible student incurs \$2,000 of qualified tuition and related expenses, then he or she is eligible for a \$1,500 HOPE credit.

⁵⁶ The HOPE credit may not be claimed against a taxpayer's alternative minimum tax liability.

imum HOPE credit amount and the AGI phase-out ranges are indexed for inflation.

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

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

Lifetime Learning credit

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

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer’s return will not vary based on the number of students in the taxpayer’s family—that is, the HOPE credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). The phase-out ranges are adjusted for inflation for taxable years beginning after 2001.

Reasons for Change

The Congress recognized that in some cases a deduction for education expenses may provide greater tax relief than the present-law credits. The Congress wished to maximize tax benefits for education, and provide greater choice for taxpayers in determining which tax benefit is most appropriate for them.

Explanation of Provision

EGTRRA permits taxpayers an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses are defined in the same manner as for purposes of the HOPE credit.

In 2002 and 2003, taxpayers with adjusted gross income⁵⁷ that does not exceed \$65,000 (\$130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of \$3,000 per year. Taxpayers with adjusted gross income above these thresholds would not be entitled to a deduction. In 2004 and 2005, taxpayers with adjusted gross income that does not exceed \$65,000 (\$130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of \$4,000 and taxpayers with adjusted gross income that does not exceed \$80,000 (\$160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of \$2,000.

Taxpayers are not eligible to claim the deduction and a HOPE or Lifetime Learning Credit in the same year with respect to the same student. A taxpayer may claim in the same year the deduction, the exclusion for distributions from an education individual retirement account, and the exclusion for interest on education savings bonds, as long as the deductions and exclusion are not claimed with respect to the same expenses. A taxpayer may also claim, in the same year, both the deduction and an exclusion for distributions from a qualified tuition program. Additionally, a taxpayer may claim the deduction with respect to the same expenses that are used to claim an exclusion for a distribution from a qualified tuition program, but only to the extent of the amount of the distribution representing a return of contributions.

Effective Date

The provision is effective for payments made in taxable years beginning after December 31, 2001, and before January 1, 2006.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$1,535 million in 2002, \$2,063 million in 2003, \$2,683 million in 2004, \$2,911 million in 2005 and \$730 million in 2006.

⁵⁷The provision contains ordering rules for use in determining adjusted gross income for purposes of the deduction.

V. ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

A. Phaseout and Repeal of Estate and Generation-Skipping Transfer Taxes; Increase in Gift Tax Unified Credit Effective Exemption (secs. 501, 511, 521, 531, 532, 541 and 542 of the Act, secs. 121, 684, 1014, 1040, 1221, 2001-2210, 2501, 2502, 2503, 2505, 2511, 2601-2663, 4947, 6018, 6019, and 7701 of the Code, and new secs. 1022, 2058, 2210, 2664, and 6716 of the Code)

Present and Prior Law

Estate and gift tax rules

In general

Under present and prior law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. Under prior law, the unified estate and gift tax rates began at 18 percent on the first \$10,000 of cumulative taxable transfers and reached 55 percent on cumulative taxable transfers over \$3 million. Also, under prior law, a 5-percent surtax was imposed on cumulative taxable transfers between \$10 million and \$17,184,000, which had the effect of phasing out the benefit of the graduated rates. Thus, these estates were subject to a top marginal rate of 60 percent. Under prior law, estates over \$17,184,000 were subject to a flat rate of 55 percent on all amounts exceeding the unified credit effective exemption amount, as the benefit of the graduated rates had been phased out.

Gift tax annual exclusion

Under present and prior law, donors of lifetime gifts are provided an annual exclusion of \$10,000 (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2001 remained at \$10,000) on transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$20,000 (subject to the inflation adjustments mentioned above.) Unlimited transfers between spouses are permitted without imposition of a gift tax.

Unified credit

Under present and prior law, a unified credit is available with respect to taxable transfers by gift and at death. Under prior law, the unified credit amount effectively exempted from tax transfers

totaling \$675,000 in 2001, \$700,000 in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million in 2006 and thereafter. The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2001, the unified credit applied between the 18-percent and 37-percent estate and gift tax rates. Thus, in 2001, taxable transfers, after application of the unified credit, were effectively subject to estate and gift tax rates beginning at 37 percent.

Transfers to a surviving spouse

In general.—Under present and prior law, a 100-percent marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of a “qualified terminable interest” also are eligible for the marital deduction. A “qualified terminable interest” is property: (1) which passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use property during the spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens.—Under present and prior law, a marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

There is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Expenses, indebtedness, and taxes

Under present and prior law, an estate tax deduction is allowed for funeral expenses and administration expenses of an estate. An estate tax deduction also is allowed for claims against the estate and unpaid mortgages on, or any indebtedness in respect of, property for which the value of the decedent’s interest therein, undiminished by the debt, is included in the value of the gross estate.

If the total amount of claims and debts against the estate exceeds the value of the property to which the claims relate, an estate tax deduction for the excess is allowed, provided such excess is paid before the due date of the estate tax return. A deduction for claims against the estate generally is permitted only if the claim is allowable by the law of the jurisdiction under which the estate is being administered.

A deduction also is allowed for the full unpaid amount of any mortgage upon, or of any other indebtedness in respect of, any property included in the gross estate (including interest which has accrued thereon to the date of the decedent's death), provided that the full value of the underlying property is included in the decedent's gross estate.

Basis of property received

In general.—Gain or loss, if any, on the disposition of the property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Under present and prior law, property received from a donor of a lifetime gift takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of gift.

Under present and prior law, property passing from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death, and has the effect of eliminating the tax benefit from any unrealized loss.

Special rule for community property.—In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent, and thus is eligible for stepped-up basis. Under present and prior law, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Special rules for interests in certain foreign entities.—Under present and prior law, stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock or securities in a foreign personal holding company take a carryover basis, and stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing

fund election is allowed a stepped-up basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of the company's accumulated earnings and profits, and stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Provisions affecting small and family-owned businesses and farms

Special-use valuation.—Under present and prior law, an executor can elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is \$750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2001 was \$800,000). Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction.—Under present and prior law, an estate is permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to \$675,000.⁵⁸ A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the

⁵⁸The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit effective exemption amount is \$625,000, for a total of \$1.3 million. If the qualified family-owned business deduction is less than \$675,000, then the unified credit effective exemption amount is equal to \$625,000, increased by the difference between \$675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above such amount in effect for the taxable year.

year of the decedent's death was personal holding company income. In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death.

The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent's death, then 100 percent of the tax is recaptured. The remaining percentage of recapture based on the year after the decedent's death in which a disqualifying event occurs is as follows: the disqualifying event occurs during the seventh year after the decedent's death, 80 percent; during the eighth year after the decedent's death, 60 percent; during the ninth year after the decedent's death, 40 percent; and during the tenth year after the decedent's death, 20 percent. For purposes of the qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

An estate can claim the benefits of both the qualified family-owned business deduction and special-use valuation. For purposes of determining whether the value of the trade or business exceeds 50 percent of the decedent's gross estate, then the property's special-use value is used if the estate claimed special-use valuation.

State death tax credit

Under present and prior law, a credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. Under prior law, the maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States impose a "pick-up" or "soak-up" estate tax, which serves to impose a State tax equal to the maximum Federal credit allowed.

Estate and gift taxation of nonresident noncitizens

Under present and prior law, nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Estates of nonresident noncitizens generally are taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death. This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Special rules apply which treat certain property as being situated within and without the United States for these purposes.

Unless modified by a treaty, a nonresident who is not a U.S. citizen generally is allowed a unified credit of \$13,000, which effectively exempts \$60,000 in assets from estate tax.

Generation-skipping transfer tax

Under present and prior law, a generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. Under prior law, the generation-skipping transfer tax was imposed at a flat rate of 55 percent (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of \$1 million (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2001 is \$1,060,000).

Selected income tax provisions*Transfers to certain foreign trusts and estates*

Under present and prior law, a transfer (during life or at death) by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. Under prior law, the amount of gain that had to be recognized by the transferor was equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

Net operating loss and capital loss carryovers

Under present and prior law, a capital loss and net operating loss from business operations sustained by a decedent during his last taxable year are deductible only on the final return filed in his or her behalf. Such losses are not deductible by his or her estate.

Transfers of property in satisfaction of a pecuniary bequest

Under prior law, gain or loss was recognized on the transfer of property in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount) to the extent that the fair market value of

the property at the time of the transfer exceeded the basis of the property, which generally was the basis stepped up to fair market value on the date of the decedent's death.

Income tax exclusion for the gain on the sale of a principal residence

Under present and prior law, a taxpayer generally can 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. The exclusion is allowed each time a taxpayer sells or exchanges a principal residence that meets the eligibility requirements, but generally no more frequently than once every two years.

Generally a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or certain unforeseen circumstances prescribed by regulation is able to exclude the fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

Excise tax on non-exempt trusts

Under present and prior law, non-exempt split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income, estate, or gift tax charitable deduction was allowed with respect to the trust. A non-exempt split-interest trust subject to these rules is prohibited from engaging in self-dealing, retaining any excess business holdings, and from making certain investments or taxable expenditures. Failure to comply with these restrictions would subject the trust to certain excise taxes imposed on private foundations, which include excise taxes on self-dealing, excess business holdings, investments which jeopardize charitable purposes, and certain taxable expenditures.

Reasons for Change

The Congress found the estate and generation-skipping transfer taxes unduly burdensome on affected taxpayers, and particularly decedents' estates, decedents' heirs, and businesses, such as small businesses, family-owned businesses, and farming businesses. The Congress believed further that it was inappropriate to impose a tax by reason of death of the taxpayer. In addition, the Congress believed that increasing the gift tax unified credit effective exemption amount and reducing gift tax rates would lessen the burden that gift taxes impose on all taxpayers and promote simplification for those taxpayers who would no longer be subject to the gift tax.

*Explanation of Provision****Reduction in estate, gift, and generation-skipping transfer taxes; repeal of estate and generation-skipping transfer taxes****In general*

Under the provision, the estate, gift, and generation-skipping transfer taxes are reduced between 2002 and 2009, and the estate and generation-skipping transfer taxes are repealed in 2010.

Beginning in 2002, the 5-percent surtax (which phases out the benefit of the graduated rates) and the rates in excess of 50 percent are repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to \$1 million. In 2003, the estate and gift tax rates in excess of 49 percent are repealed. In 2004, the estate and gift tax rates in excess of 48 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to \$1.5 million. (The unified credit effective exemption amount for gift tax purposes remains at \$1 million as increased in 2002.) In addition, in 2004, the family-owned business deduction is repealed. In 2005, the estate and gift tax rates in excess of 47 percent are repealed. In 2006, the estate and gift tax rates in excess of 46 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to \$2 million. In 2007, the estate and gift tax rates in excess of 45 percent are repealed. In 2009, the unified credit effective exemption amount is increased to \$3.5 million. In 2010, the estate and generation-skipping transfer taxes are repealed.

From 2002 through 2009, the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes are as follows:

Table 8.—Unified Credit Exemption Equivalent Amount and Estate and Gift Tax Rates for 2002–2009

Calendar year	Estate and GST tax transfer exemption	Highest estate and gift tax rates (percent)
2002	\$1 million	50
2003	\$1 million	49
2004	\$1.5 million	48
2005	\$1.5 million	47
2006	\$2 million	46
2007	\$2 million	45
2008	\$2 million	45
2009	\$3.5 million	45
2010	N/A (taxes repealed)	Top individual income tax rate (gift tax only).

The generation-skipping transfer tax exemption for a given year (prior to repeal) is equal to the unified credit effective exemption amount for estate tax purposes. The generation-skipping transfer

tax rate for a given year will be the highest estate and gift tax rate in effect for such year.

Repeal of estate and generation-skipping transfer taxes; modifications to gift tax

In 2010, the estate and generation-skipping transfer taxes are repealed. Also in 2010, the top gift tax rate will be the otherwise applicable top individual income tax rate, and, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.⁵⁹

Reduction in State death tax credit; deduction for State death taxes paid

Under the provision, from 2002 through 2004, the State death tax credit allowable under prior law is reduced as follows: in 2002, the State death tax credit is reduced by 25 percent (from prior law amounts); in 2003, the State death tax credit is reduced by 50 percent (from prior law amounts); and in 2004, the State death tax credit is reduced by 75 percent (from prior law amounts). In 2005, the State death tax credit is repealed, after which there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Basis of property acquired from a decedent

In general

In 2010, after repeal of the estate tax, the present and prior-law rules providing for a fair market value basis for property acquired from a decedent are repealed. Instead, a modified carryover basis regime generally takes effect. Recipients of property transferred at

⁵⁹ EGTRRA's Conference Report (H.R. Rep. 107-84) stated that a transfer in trust will be treated as a taxable gift. Section 411 of The "Job Creation and Worker Assistance Act of 2002" described in Part Eight of this document; includes a technical correction to clarify that the effect of section 511(e) of EGTRRA the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. Sec. 25.2511-2(c). Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life, and makes no transfer of a remainder interest, the entire value of the property will be treated as being transferred by gift under the provision.

the decedent's death will receive a basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death.

Under the provision, the modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply.⁶⁰

Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

Property to which the modified carryover basis rules apply

The modified carryover basis rules apply to property acquired from the decedent. Property acquired from the decedent is: (1) property acquired by bequest, devise, or inheritance, (2) property acquired by the decedent's estate from the decedent, (3) property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust,⁶¹ (4) property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust,⁶² (5) property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties), and (6) the surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.

Basis increase for certain property

Amount of basis increase.—The provision allows an executor to increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death. Under this rule, each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of \$1.3 million. The \$1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse can be increased by an additional \$3 million. Thus, the basis of property transferred to surviving spouses can be increased by a total of \$4.3 million. Nonresidents who are not U.S. citizens will be

⁶⁰Section 1014(b)(2) and (3).

⁶¹This is the same property the basis of which is stepped up to date of death fair market value under prior law section 1014(b)(2).

⁶²This is the same property the basis of which is stepped up to date of death fair market value under prior-law section 1014(b)(3).

allowed to increase the basis of property by up to \$60,000. The \$60,000, \$1.3 million, and \$3 million amounts are adjusted annually for inflation occurring after 2010.

Property eligible for basis increase.—In general, the basis of property may be increased above the decedent's adjusted basis in that property only if the property is owned, or is treated as owned, by the decedent at the time of the decedent's death. In the case of property held as joint tenants or tenants by the entirety with the surviving spouse, one-half of the property is treated having been owned by the decedent and is thus eligible for the basis increase. In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase. The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent. The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent.⁶³ The decedent shall not, however, be treated as owning any property solely by reason of holding a power of appointment with respect to such property.

Property not eligible for a basis increase includes: (1) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death; (2) property that constitutes a right to receive income in respect of a decedent; (3) stock or securities of a foreign personal holding company; (4) stock of a domestic international sales corporation (or former domestic international sales corporation); (5) stock of a foreign investment company; and (6) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

Rules applicable to basis increase.—Basis increase will be allocable on an asset-by-asset basis (e.g., basis increase can be allocated to a share of stock or a block of stock). However, in no case can the basis of an asset be adjusted above its fair market value. If the amount of basis increase is less than the fair market value of assets whose bases are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase.

Reporting requirements

Lifetime gifts

A donor is required to provide to recipients of property by gift the information relating to the property (e.g. the fair market value and basis of property) that was reported on the donor's gift tax return with respect to such property.

⁶³ Thus, similar to the prior-law rule in section 1014(b)(6), both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase.

Transfers at death

For transfers at death of non-cash assets in excess of \$1.3 million and for appreciated property received by a decedent via reportable gift within three years of death, the executor of the estate (or the trustee of a revocable trust) would report to the IRS:

- The name and taxpayer identification number of the recipient of the property,
- An accurate description of the property,
- The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
- The decedent's holding period for the property,
- Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- The amount of basis increase allocated to the property, and
- Any other information as the Treasury Secretary may prescribe.

Penalties for failure to comply with the reporting requirements

Any donor required to provide to recipients of property by gift the information relating to the property that was reported on the donor's gift tax return (e.g., the fair market value and basis of property) with respect to such property who fails to do so is liable for a penalty of \$50 for each failure to report such information to a donee.

Any person required to report to the IRS transfers at death of non-cash assets in excess of \$1.3 million in value who fails to do so is liable for a penalty of \$10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property acquired by the decedent within three years of death for which a gift tax return was required to have been filed by the donor who fails to do so is liable for a penalty of \$500 for the failure to report such information to the IRS. There also is a penalty of \$50 for each failure to report such information to a beneficiary.

No penalty is imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under EGTRRA is due to intentional disregard of the rules, then the penalty is five percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift).

Certain tax benefits extending past the date for repeal of the estate tax*In general*

Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax. Because repeal of the estate tax is effective for decedents dying after December 31, 2010, these estate tax recapture provisions will continue to apply to estates of decedents dying before January 1, 2011.

There will be (1) an additional estate tax for those with a retained development right with respect to property for which a conservation easement was claimed, (2) an additional estate tax imposed under the special-use valuation rules, (3) an additional tax imposed under the qualified family-owned business deduction rules, and (4) an acceleration of tax under the installment payment of estate tax provisions.

There will also be an estate tax imposed on (1) any distribution prior to January 1, 2021, from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2010.

Qualified conservation easements

A donor may have retained a development right in the conveyance of a conservation easement that qualified for the estate tax exclusion. Those with an interest in the land may later execute an agreement to extinguish the right. If an agreement to extinguish development rights is not entered into within the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement, then those with an interest in the land are personally liable for an additional tax. This provision is retained after repeal of the estate tax, which will ensure that those persons with an interest in the land who fail to execute the agreement remain liable for any additional tax which may be due after repeal.

Special-use valuation

Property may have qualified for special-use valuation prior to repeal of the estate tax. If such property ceases to qualify for special-use valuation, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate tax benefit is required to be recaptured. The recapture provision is retained after repeal of the estate tax, which will ensure that those estates that claimed this benefit prior to repeal of the estate tax will be subject to recapture if a disqualifying event occurs after repeal.

Qualified family-owned business deduction

Property may have qualified for the family-owned business deduction prior to repeal of the estate tax. If such property ceases to qualify for the family-owned business deduction, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate-tax benefit is required to be recaptured. The recapture provision is retained after repeal of the estate tax, which will ensure that those estates that claimed this benefit prior to repeal of the estate tax would be subject to recapture if a disqualifying event occurs after repeal.

Installment payment of estate tax for estates with an interest in a closely-held business

The present and prior-law installment payment rules are retained so that those estates that entered into an installment pay-

ment arrangement prior to repeal of the estate tax will continue to make their payments past the date for repeal. A more complete description of the present and prior law installment payment rules is included in the discussion of secs. 571 and 572 of EGTRRA, below.

If more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary. This rule is retained after repeal of the estate tax, which will ensure that such dispositions that occur after repeal of the estate tax will continue to subject the estate to the unpaid portion of the tax upon notice and demand.

Transfers to foreign trusts, estates, and nonresidents who are not U.S. citizens

The prior-law rule providing that transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange is expanded. Under EGTRRA, beginning in 2010, a transfer by a U.S. person's estate (i.e., by a U.S. person at death) to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor.

Transfers of property in satisfaction of a pecuniary bequest

Under EGTRRA, gain or loss on the transfer of property in satisfaction of a pecuniary bequest is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).

Transfer of property subject to a liability

EGTRRA clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate by reason of the liability.

Income tax exclusion for the gain on the sale of a principal residence

Under EGTRRA, the income tax exclusion of up to \$250,000 of gain on the sale of a principal residence is extended to estates and heirs. Under the provision, if the decedent's estate or an heir sells the decedent's principal residence, \$250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of ownership and occupancy of the property as a principal residence can be added to the heir's subsequent ownership and occupancy in deter-

mining whether the property was owned and occupied for two years as a principal residence.

The income tax exclusion for the gain on the sale of a principal residence also applies to property sold by a trust that was a qualified revocable trust under section 645 of the Code immediately prior to the decedent's death. The decedent's period of occupancy of the property as a principal residence can be added to an heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence, regardless of whether the residence was owned by such trust during the decedent's occupancy.

Excise tax on nonexempt trusts

Under EGTRRA, split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust.⁶⁴

Effective Date

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount, and reductions in and repeal of the state death tax credit are phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers after December 31, 2001. The repeal of the qualified family-owned business deduction is effective for estates of decedents dying after December 31, 2003.

The estate and generation-skipping transfer taxes are repealed, and the carryover basis regime takes effect for estates of decedents dying and generation-skipping transfers after December 31, 2009. The provisions relating to recognition of gain on transfers by the estate of a U.S. person (i.e., at death) to nonresidents who are not U.S. citizens is effective for transfers made after December 31, 2009.

The top gift tax rate will be the top otherwise applicable individual income tax rate, and transfers to trusts generally will be treated as a taxable gift unless the trust is treated as wholly owned by the donor or the donor's spouse, effective for gifts made after December 31, 2009.

An estate tax on distributions made from a qualified domestic trust before the date of the death of the surviving spouse will no longer apply for distributions made after December 31, 2020. An estate tax on the value of property remaining in a qualified domestic trust on the date of death of the surviving spouse will no longer apply after December 31, 2009.

Revenue Effect

The provision is estimated to reduce Federal fiscal year revenues by \$6,383 million in 2003, \$5,031 million in 2004, \$7,054 million in 2005, \$4,051 million in 2006, \$9,695 million in 2007, \$11,862

⁶⁴Text of footnote intentionally deleted.

million in 2008, \$12,701 million in 2009, \$23,036 million in 2010, and \$53,422 million in 2011.

B. Expand Estate Tax Rule for Conservation Easements (sec. 551 of the Act and sec. 2031 of the Code)

Present and Prior Law

In general

Under present and prior law, an executor can elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$100,000 in 1998, \$200,000 in 1999, \$300,000 in 2000, \$400,000 in 2001, and \$500,000 in 2002 and thereafter (section 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Under prior law, a qualified conservation easement was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) was granted by the decedent or a member of his or her family. Under present and prior law, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Under present and prior law, in order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property.

Retained development rights

Under present and prior law, the exclusion for land subject to a conservation easement does not apply to any development right retained by the donor in the conveyance of the conservation easement. An example of such a development right is the right to extract minerals from the land. If such development rights exist, then the value of the conservation easement must be reduced by the value of any retained development right.

If the donor or holders of the development rights agree in writing to extinguish the development rights in the land, then the value of the easement need not be reduced by the development rights. In such case, those persons with an interest in the land must execute the agreement no later than the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement. If such agreement is not entered into within this time, then those with an interest in the land are personally liable for an additional tax, which is the amount of tax which would have been due on the retained development rights subject to the termination agreement.

Reasons for Change

The Congress believed that expanding the availability of qualified conservation easements would further ease existing pressures to develop or sell environmentally significant land in order to raise funds to pay estate taxes and would, thereby, advance the preservation of such land. The Congress also believed it was appropriate to clarify the date for determining easement compliance.

Explanation of Provision

EGTRRA expands the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. The provision also clarifies that the date for determining easement compliance is the date on which the donation is made.

Effective Date

The provisions are effective for estates of decedents dying after December 31, 2000.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by \$3 million in 2002, \$19 million in 2003, \$28 million in 2004, \$29 million in 2005, \$30 million in 2006, \$32 million in 2007, \$34 million in 2008, \$36 million in 2009, \$39 million in 2010, and \$42 million in 2011.

C. Modify Generation-Skipping Transfer Tax Rules

1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips (sec. 561 of the Act and sec. 2632 of the Code)

Present and Prior Law

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable ter-

minations, and taxable distributions. An exemption of \$1 million (indexed beginning in 1999; the inflation-adjusted amount for 2001 was \$1,060,000) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55 percent under prior law) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust. The allocation of generation-skipping transfer tax exemption reduces the 55-percent tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under prior law, for lifetime transfers made to a trust that were not direct skips, the transferor had to allocate generation-skipping transfer tax exemption—the allocation was not automatic. If generation-skipping transfer tax exemption was allocated on a timely-filed gift tax return, then the portion of the trust which was exempt from generation-skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely-filed gift tax return, then the portion of the trust which was exempt from generation-skipping transfer tax was based on the value of the property at the time the allocation of generation-skipping transfer tax exemption was made.

Treasury Regulations⁶⁵ further provides that any unused generation-skipping transfer tax exemption, which has not been allocated to transfers made during an individual's life, is automatically allocated on the due date for filing the decedent's estate tax return. Unused generation-skipping transfer tax exemption is allocated pro rata on the basis of the value of the property as finally determined

⁶⁵Treas. Reg. sec. 26.2632-1(d).

for estate tax purposes, first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused generation-skipping transfer tax exemption is allocated pro rata, on the basis of the estate tax value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made.

Reasons for Change

The Congress recognized that there are situations where a taxpayer would desire allocation of generation-skipping transfer tax exemption, yet the taxpayer had missed allocating generation-skipping transfer tax exemption to an indirect skip, e.g., because the taxpayer or the taxpayer's advisor inadvertently omitted making the election on a timely-filed gift tax return or the taxpayer submitted a defective election. The Congress believed that automatic allocation is appropriate for transfers to a trust from which generation-skipping transfers are likely to occur.

Explanation of Provision

EGTRRA provides that generation-skipping transfer tax exemption will be automatically allocated to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

A generation-skipping transfer trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless:

- The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46;
- The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;
- The trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals;

- The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;
- The trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable remainder unitrust; or
- The trust is a trust with respect to which a deduction was allowed under section 2522 of the Code for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

Under EGTRRA, if any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual can elect not to have the automatic allocation rules apply to an indirect skip, and such elections will be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual can elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and can elect to treat any trust as a generation-skipping transfer trust with respect to any or all transfers made by the individual to such trust, and such election can be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

Effective Date

The provision applies to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$1 million in 2002, \$3 million in 2003, and \$4 million annually in 2004 through 2011.

2. Retroactive allocation of the generation-skipping transfer tax exemption (sec. 561 of the Act and sec. 2632 of the Code)

Present and Prior Law

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a

taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable termination or taxable distribution, generation-skipping transfer tax may be avoided.

Under present and prior law, a transferor likely will not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and generation-skipping transfer tax exemption had not been allocated to the trust, then, under prior law, generation-skipping transfer tax was due even if the transferor had unused generation-skipping transfer tax exemption.

Reasons for Change

The Congress recognized that when a transferor does not expect the second generation (e.g., the transferor's child) to die before the termination of the trust, the transferor likely will not allocate generation-skipping transfer tax exemption to the transfer to the trust. If the transferor knew, however, that the transferor's child might predecease the transferor and that there could be a taxable termination as a result thereof, the transferor likely would have allocated generation-skipping transfer tax exemption at the time of the transfer to the trust. The Congress believed it was appropriate to provide that when there is an unnatural order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate generation-skipping transfer tax exemption retroactively to the date of the respective transfer to the trust.

Explanation of Provision

EGTRRA provides that generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. EGTRRA allows a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary: (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption is allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

Effective Date

The provision applies to deaths of non-skip persons occurring after December 31, 2000.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$1 million in 2002, \$4 million in 2003, and \$6 million annually in 2004 through 2011. This estimate includes the combined revenue effects related to this provision and the provisions relating to the severing of trusts holding property having an inclusion ratio greater than zero, the modification of certain valuation rules, the relief from late elections, and the provision relating to substantial compliance.

3. Severing of trusts holding property having an inclusion ratio of greater than zero (sec. 562 of the Act and sec. 2642 of the Code)

Present and Prior Law

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of \$1 million (indexed beginning in 1999; the inflation-adjusted amount for 2001 was \$1,060,000) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

If the value of transferred property exceeds the amount of the generation-skipping transfer tax exemption allocated to that property, then the generation-skipping transfer tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is 55 percent for 2001) by the “inclusion ratio” and the value of the taxable property at the time of the taxable event. The “inclusion ratio” is the number one minus the “applicable fraction.” The applicable fraction is a fraction calculated by dividing the amount of the generation-skipping transfer tax exemption allocated to the property by the value of the property.

Under Treasury regulations⁶⁶ a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee’s discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under prior law, pursuant to Treasury regulations, a trustee could not establish inclusion ratios of zero and one by severing a trust that was subject to the generation-skipping transfer tax after the trust had been created.

Reasons for Change

The Congress recognized that complexity could be reduced if a generation-skipping transfer trust is treated as two separate trusts for generation-skipping transfer tax purposes—one with an inclu-

⁶⁶Treas. Reg. sec. 26.2654-1(b).

sion ratio of zero and one with an inclusion ratio of one. It was possible to achieve this result by drafting complex documents in order to meet the specific requirements of severance. The Congress believed that it was appropriate to make the rules regarding severance less burdensome and less complex.

Explanation of Provision

The provision provides that a trust can be severed in a “qualified severance.” A qualified severance is defined as the division of a single trust and the creation of two or more trusts if: (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under EGTRRA, a trustee may elect to sever a trust in a qualified severance at any time.

Effective Date

The provision is effective for severances of trusts occurring after December 31, 2000.

Revenue Effect

The estimated revenue effect of this provision is included in the estimates for the retroactive allocation of the generation-skipping tax exemption.

4. Modification of certain valuation rules (sec. 563 of the Act and sec. 2642 of the Code)

Present and Prior Law

Under present and prior law, the inclusion ratio is determined using gift tax values for allocations of generation-skipping transfer tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of generation-skipping transfer tax exemption made to transfers at death. Treasury regulations⁶⁷ provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor’s estate.

⁶⁷Treas. Reg. sec. 26.2642-5(b).

Reasons for Change

The Congress believed it was appropriate to clarify the valuation rules relating to timely and automatic allocations of generation-skipping transfer tax exemption.

Explanation of Provision

EGTRRA provides that in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Effective Date

The provision is effective for transfers subject to estate or gift tax made after December 31, 2000.

Revenue Effect

The estimated revenue effect of this provision is included in the estimates for the retroactive allocation of the generation-skipping tax exemption.

5. Relief from late elections (sec. 564 of the Act and sec. 2642 of the Code)

Present and Prior Law

Under present and prior law, an election to allocate generation-skipping transfer tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to the trust is used for determining generation-skipping transfer tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. Under prior law, there was no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate generation-skipping transfer tax exemption.

Reasons for Change

The Congress believed it was appropriate for the Treasury Secretary to grant extensions of time to make an election to allocate generation-skipping transfer tax exemption and to grant exceptions to the statutory time requirement in appropriate circumstances, e.g., when the taxpayer intended to allocate generation-skipping transfer tax exemption and failure to timely allocate generation-skipping transfer tax exemption was inadvertent.

Explanation of Provision

Under EGTRRA, the Treasury Secretary is authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.

Effective Date

The provision applies to requests pending on, or filed after, December 31, 2000. No inference is intended with respect to the availability of relief from late elections prior to the effective date of the provision.

Revenue Effect

The estimated revenue effect of this provision is included in the estimates for the retroactive allocation of the generation-skipping tax exemption.

6. Substantial compliance (sec. 564 of the Act and sec. 2642 of the Code)

Present and Prior Law

Under prior law, there was no statutory rule which provided that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption would suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.

Reasons for Change

The Congress recognized that the rules and regulations regarding the allocation of the generation-skipping transfer tax are complex. Thus, it is often difficult for taxpayers to comply with the technical requirement for making a proper election to allocate generation-skipping transfer tax exemption. The Congress therefore believed it was appropriate to provide that generation-skipping transfer tax exemption will be allocated when a taxpayer substantially complies with the rules and regulations for allocating generation skipping transfer tax exemption.

Explanation of Provision

EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-

skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

Effective Date

The provision applies to transfers subject to estate or gift tax made after December 31, 2000. No inference is intended with respect to the availability of a rule of substantial compliance prior to the effective date of the provision.

Revenue Effect

The estimated revenue effect of this provision is included in the estimates for the retroactive allocation of the generation-skipping tax exemption.

D. Expand and Modify Availability of Installment Payment of Estate Tax for Closely-Held Businesses (secs. 571, 572 and 573 of the Act and sec. 6166 of the Code)

Present and Prior Law

Under present and prior law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely-held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.⁶⁸ A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2001 is \$1,060,000) in taxable value of a closely-held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely-held business in excess of \$1 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

⁶⁸For example, assume estate tax is due in 2001. If interest only is paid each year for the first five years (2001 through 2005), and if 10 installments of both principal and interest are paid for the 10 years thereafter (2006 through 2015), then payment of the estate tax would be extended by 14 years from the original due date of 2001.

Under prior law, for purposes of these rules, an interest in a closely-held business was: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and prior law, the decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the 2-percent interest rate do not apply. The value of any interest in a closely-held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Reasons for Change

The Congress found that the prior-law installment payment of estate tax provisions were restrictive and prevented estates of decedents who otherwise held an interest in a closely-held business at death from claiming the benefits of installment payment of the estate tax. The Congress wished to expand and modify availability of the provision to enable more estates of decedents with an interest in a closely-held business to claim the benefits of installment payment of estate tax.

Explanation of Provision

EGTRRA expands the definition of a closely-held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the number of partners in a partnership and shareholders in a corporation that is considered a closely-held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must

make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

No inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under prior law.

Effective Date

The provision is effective for decedents dying after December 31, 2001.

Revenue Effect

The provision to increase from 15 to 45 the number of partners a partnership or shareholders in a corporation eligible for installment payments of estate tax is estimated to reduce Federal fiscal year revenues by \$285 million in 2003, \$297 million in 2004, \$330 million in 2005, \$364 million in 2006, \$394 million in 2007, \$383 million in 2008, \$381 million in 2009, \$371 million in 2010, and \$358 million in 2011.

The provision to expand the availability of installment payments of estate tax to qualified lending and finance business interest is estimated to reduce Federal fiscal year budget receipts by \$103 million in 2003, \$84 million in 2004, \$64 million in 2005, \$43 million in 2006, \$21 million in 2007, \$22 million in 2008, \$24 million in 2009, \$25 million in 2010, and \$27 million in 2011.

The provision clarifying the treatment of certain holding company stock is estimated to reduce Federal fiscal year budget receipts by \$171 million in 2003, \$140 million in 2004, \$107 million in 2005, \$72 million in 2006, \$34 million in 2007, \$47 million in 2008, \$49 million in 2009, \$42 million in 2010, and \$45 million in 2011.

E. Waiver of Statute of Limitations for Refunds of Recapture of Estate Tax (sec. 581 of the Act and sec. 2032A of the Code)⁶⁹

Present and Prior Law

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, family farms and real property used in other closely held businesses may be included in a decedent's estate at their current use value, rather than full fair market value (section 2032A). Under present and prior law, family farms and real property are given qualified use treatment even if a surviving spouse or lineal descendent of the decedent enter into a net cash lease on such property with their respective family members (section 2032A(c)(7)(E)).

⁶⁹This was a Senate floor amendment and was not described in EGTRRA's Conference Report (H.R. Rep. No. 107-84).

Explanation of Provision

If a refund or credit of any overpayment of tax resulting from the application of Code section 2032A(c)(7)(E) is barred by any law or rule of law, the refund or credit of such overpayment shall, nevertheless, be made or allowed if the taxpayer files a claim up until 1 year after the date of enactment of EGTRRA.

Effective Date

This provision is effective on the date of enactment of EGTRRA for any time up until 1 year after such date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$100 million in 2002 and \$25 million in 2003.

**VI. PENSION AND INDIVIDUAL RETIREMENT
ARRANGEMENT PROVISIONS**

**A. Individual Retirement Arrangements (“IRAs”) (secs. 601–
602 of the Act and secs. 219, 408, and 408A of the Code)**

Present and Prior Law

In general

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

Traditional IRAs

Under present and prior law, an individual may make deductible contributions to an IRA up to the lesser of a dollar limit (\$2,000 under prior law) or the individual’s compensation if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to the dollar limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income (“AGI”) over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Taxable years beginning in:	Phase-out range:
<i>Single taxpayers</i>	
2001	\$33,000–43,000
2002	34,000–44,000
2003	40,000–50,000
2004	45,000–55,000
2005 and thereafter	50,000–60,000
<i>Joint returns</i>	
2001	\$53,000–63,000
2002	54,000–64,000
2003	60,000–70,000
2004	65,000–75,000
2005	70,000–80,000
2006	75,000–85,000

Taxable years beginning in:	Phase-out range:
2007 and thereafter	\$80,000–100,000

The AGI phase-out range for married taxpayers filing a separate return is \$0 to \$10,000.

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

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to \$10,000.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of a dollar limit (\$2,000 under prior law) or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to 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 single individuals with AGI between \$95,000 and \$110,000 and for joint filers with AGI between \$150,000 and \$160,000.

Taxpayers with modified AGI of \$100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that: (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earn-

ings, and subject to the 10-percent early withdrawal tax (unless an exception applies).⁷⁰ The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

Reasons for Change

The Congress was concerned about the low national savings rate, and that individuals may not be saving adequately for retirement. The prior-law IRA contribution limits had not been increased since 1981. The Congress believed that the limits should be raised in order to allow greater savings opportunities.

The Congress understood that, for a variety of reasons, older individuals may not have been saving sufficiently for retirement. For example, some individuals, especially women, may have left the workforce temporarily in order to care for children. Such individuals may have missed retirement savings options that would have been available had they remained in the workforce.

Explanation of Provision

Increase in annual contribution limits

EGTRRA increases the maximum annual dollar contribution limit for IRA contributions from \$2,000 to \$3,000 for 2002 through 2004, \$4,000 for 2005 through 2007, and \$5,000 for 2008. After 2008, the limit is adjusted annually for inflation in \$500 increments.

Additional catch-up contributions

EGTRRA provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by \$500 for 2002 through 2005, and \$1,000 for 2006 and thereafter.

Deemed IRAs under employer plans⁷¹

EGTRRA provides that, if a qualified employer plan permits employees to make voluntary employee contributions to a separate account or annuity that: (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs apply. The deemed IRA, and contributions thereto, are not subject to the Code rules pertaining to the qualified employer plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, are subject to the exclusive benefit, fiduciary duty, and administration and enforcement rules of the Employee Retirement Income Security

⁷⁰ Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

⁷¹ A technical correction was enacted in section 411(i) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify the plans to which the EGTRRA provision applies.

Act of 1974 (“ERISA”), which are to be applied in a manner similar to their application to a simplified employee pension (a “SEP”). The deemed IRA, and contributions thereto, are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan.⁷² For purposes of the provision, a qualified employer plan is a qualified retirement plan (section 401(a)), a qualified annuity plan (section 403(a)), a tax-sheltered annuity (section 403(b)), or a governmental eligible deferred compensation plan (section 457).

Effective Date

These provisions are generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002.

Revenue Effect

These provisions are estimated to reduce Federal fiscal year budget receipts by \$437 million in 2002, \$998 million in 2003, \$1,228 million in 2004, \$1,869 million in 2005, \$2,571 million in 2006, \$2,875 million in 2007, \$3,400 million in 2008, \$4,028 million in 2009, \$4,477 million in 2010, \$3,215 million in 2011, and \$1,768 million in 2012.

B. Pension Provisions

1. Expanding coverage

- (a) Increase in benefit and contribution limits (sec. 611 of the Act and secs. 401(a)(17), 401(c)(2), 402(g), 408(p), 415 and 457 of the Code)**

Present and Prior Law

In general

Present and prior law imposes limits on contributions and benefits under qualified plans (section 415), the amount of compensation that may be taken into account under a plan for determining benefits (section 401(a)(17)), the amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (section 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a State or local government (section 457).

Limitations on contributions and benefits

Under present and prior law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of: (1) 25 percent of compensation or (2) a certain dollar amount (\$35,000 for 2001 under prior law). Annual additions are the sum of employer contributions, employee contributions, and for-

⁷² EGTRRA does not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.

features with respect to an individual under all defined contribution plans of the same employer. Under prior law, the dollar limit was indexed for cost-of-living adjustments in \$5,000 increments.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of: (1) 100 percent of average compensation, or (2) a certain dollar amount (\$140,000 for 2001 under prior law). Under present and prior law, the dollar limit is adjusted for cost-of-living increases in \$5,000 increments.

Under prior law, in general, the dollar limit on annual benefits was reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after the social security retirement age.

Compensation limitation

Under prior law, the annual compensation of each participant that could be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes was limited to \$170,000 (for 2001), indexed for cost-of-living adjustments in \$10,000 increments.

In general, contributions to qualified plans and IRAs are based on compensation. For a self-employed individual, compensation generally means net earnings subject to self-employment taxes ("SECA taxes"). Members of certain religious faiths may elect to be exempt from SECA taxes on religious grounds. Because the net earnings of such individuals are not subject to SECA taxes, these individuals are considered to have no compensation on which to base contributions to a retirement plan. Under an exception to this rule, net earnings of such individuals are treated as compensation for purposes of making contributions to an IRA.

Elective deferral limitations

Under present and prior law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is subject to a dollar limit (\$10,500 for 2001 under prior law). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is also subject to a dollar limit (\$6,500 for 2001 under prior law). Under present and prior law, these limits are indexed for inflation in \$500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) a dollar amount (\$8,500 for 2001 under prior law) or (2) 33⅓ percent of compensation. Under present and prior law, the dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section

457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) a dollar amount (\$15,000 under prior law) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Reasons for Change

The tax benefits provided under qualified plans are a departure from the normally applicable income tax rules. The special tax benefits for qualified plans are generally justified on the ground that they serve an important social policy objective, i.e., the provision of retirement benefits to a broad group of employees. The limits on contributions and benefits, elective deferrals, and compensation that may be taken into account under a qualified plan all serve to limit the tax benefits associated with such plans. The level at which to place such limits involves a balancing of different policy objectives and a judgment as to what limits are most likely to best further policy goals.

One of the factors that may influence the decision of an employer, particularly a small employer, to adopt a plan is the extent to which the owners of the business, the decision-makers, or other highly compensated employees will benefit under the plan. The Congress believed that increasing the dollar limits on qualified plan contributions and benefits would encourage employers to establish qualified plans for their employees.

The Congress understood that, in recent years, section 401(k) plans have become increasingly more prevalent. The Congress believed it was important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement.

Explanation of Provision

Limits on contributions and benefits

EGTRRA increases the \$35,000 limit on annual additions to a defined contribution plan to \$40,000.⁷³ This amount is indexed in \$1,000 increments for years after 2002.

EGTRRA increases the \$140,000 annual benefit limit under a defined benefit plan to \$160,000. This amount is indexed in \$5,000 increments (as under prior law) for years after 2002.⁷⁴ The dollar limit is reduced for benefit commencement before age 62 and in-

⁷³The 25 percent of compensation limitation is increased to 100 percent of compensation under section 632 of EGTRRA.

⁷⁴A technical correction was enacted in Section 411(j) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, that made conforming changes to provisions relating to the dollar amounts used to determine eligibility to participate in a SEP and to determine the proper period for distributions from an employee stock ownership plan ("ESOP"), which are indexed using the same method. Section 3(b) of the Tax Technical Corrections Act of 2002, introduced on November 13, 2002, as H.R. 5713 in the House of Representatives and S. 3153 in the Senate, would clarify that the prior-law \$5,000 rounding rule continues to apply for purposes of other Code provisions that refer to the method by which the limits on contributions and benefits are indexed and do not contain a specific rounding rule.

creased for benefit commencement after age 65.⁷⁵ In adopting rules regarding the application of the increase in the defined benefit plan limits under EGTRRA, it is intended that the Secretary will apply rules similar to those adopted in Notice 99-44 regarding benefit increases due to the repeal of the combined plan limit under former section 415(e).^{75A} Thus, for example, a defined benefit plan could provide for benefit increases to reflect the provisions of EGTRRA for a current or former employee who has commenced benefits under the plan prior to the effective date of the provision if the employee or former employee has an accrued benefit under the plan (other than an accrued benefit resulting from a benefit increase solely as a result of the increases in the section 415 limits under the provision). As under the notice, the maximum amount of permitted increase is generally the amount that could have been provided had the provisions of EGTRRA been in effect at the time of the commencement of benefit. In no case may benefits reflect increases that could not be paid prior to the effective date because of the limits in effect under prior law. In addition, in no case may plan amendments providing increased benefits under the relevant provision of EGTRRA be effective prior to the effective date of the provision.

Compensation limitation

EGTRRA increases the limit on compensation that may be taken into account under a plan to \$200,000. This amount is indexed in \$5,000 increments (as under prior law) for years after 2002. EGTRRA also amends the definition of compensation for purposes of all qualified plans and IRAs (including SIMPLE arrangements) to include an individual's net earnings that would be subject to SECA taxes but for the fact that the individual is covered by a religious exemption.

Elective deferral limitations

EGTRRA increases the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities and salary reduction SEPs to \$11,000 in 2002. In 2003 and thereafter, the limits are increased in \$1,000 annual increments until the limits reach \$15,000 in 2006, with indexing in \$500 increments thereafter. EGTRRA increases the maximum annual elective deferrals that may be made to a SIMPLE plan to \$7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit is increased in \$1,000 annual increments until the limit reaches \$10,000 in 2005. Beginning after 2005, the \$10,000 dollar limit is indexed in \$500 increments.

Section 457 plans

EGTRRA increases the dollar limit on deferrals under a section 457 plan to conform to the elective deferral limitation. Thus, the limit is \$11,000 in 2002, and is increased in \$1,000 annual increments thereafter until the limit reaches \$15,000 in 2006. The limit is indexed thereafter in \$500 increments. The limit is twice the

⁷⁵Section 654 of EGTRRA modifies the defined benefit plan limits for multiemployer plans.

^{75A}Rev. Rul. 2001-51, 2001-45 I.R.B. 427, provides guidance regarding the increased limits.

otherwise applicable dollar limit in the three years prior to retirement.⁷⁶

Effective Date

The provisions are generally effective for years beginning after December 31, 2001. The provisions relating to limits on benefits under a defined benefit plan are effective for years ending after December 31, 2001.⁷⁷

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by \$127 million in 2002, \$371 million in 2003, \$651 million in 2004, \$875 million in 2005, \$1,029 million in 2006, \$1,133 million in 2007, \$1,196 million in 2008, \$1,273 million in 2009, \$1,385 million in 2010, \$677 million in 2011, and \$358 million in 2012.

(b) Plan loans for S corporation shareholders, partners, and sole proprietors (sec. 612 of the Act and sec. 4975 of the Code)

Present and Prior Law

The Internal Revenue Code prohibits certain transactions (“prohibited transactions”) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries.⁷⁸ Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied. In addition, the Secretary of Labor can grant an administrative exemption from the prohibited transaction rules if the Secretary finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

Under prior law, the statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee.⁷⁹ Under present and prior law, loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan,

⁷⁶Section 632 of EGTRRA increases the 33–1/3 percentage of compensation limit to 100 percent.

⁷⁷A technical correction was enacted in section 411(j) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to provide that in the case of a plan that, on June 7, 2001 (the date of enactment of EGTRRA), incorporated the benefit limits by reference, the employer was permitted to amend such a plan by June 30, 2002, to reduce benefits to the level that applied before the enactment of EGTRRA without violating the anticutback rules that generally apply to plan amendments.

⁷⁸Title I of ERISA also contains prohibited transaction rules. The Code and ERISA provisions are substantially similar, although not identical.

⁷⁹Certain transactions involving a plan and S corporation shareholders are permitted.

bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means: (1) a sole proprietor, (2) a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than five percent of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period, and is equal to 100 percent of the amount involved.

Reasons for Change

The Congress believed that the prior-law prohibited transaction rules regarding loans unfairly discriminated against the owners of unincorporated businesses and S corporations. For example, under prior law, the sole shareholder of a C corporation could take advantage of the statutory exemption to the prohibited transaction rules for loans, but an individual doing business as a sole proprietor could not.

Explanation of Provision

EGTRRA generally eliminates the special prior-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Prior law continues to apply with respect to IRAs. The Congress intends that the Secretary of the Treasury and the Secretary of Labor will waive any penalty or excise tax in situations where a loan made prior to the effective date of the provision was exempt when initially made (treating any refinancing as a new loan) and the loan would have been exempt throughout the period of the loan if the provision had been in effect during the period of the loan.

Effective Date

The provision is effective with respect to years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$21 million in 2002, \$32 million in 2003, \$34 million in 2004, \$36 million in 2005, \$39 million in 2006, \$41 million in 2007, \$44 million in 2008, \$47 million in 2009, \$49 million in 2010, \$19 million in 2011, and \$8 million in 2012.

**(c) Modification of top-heavy rules (sec. 613 of the Act
and sec. 416 of the Code)**

Present and Prior Law

In general

Under present and prior law, additional qualification requirements apply to plans that primarily benefit an employer's key employees ("top-heavy plans"). These additional requirements provide: (1) more rapid vesting for plan participants who are nonkey employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

Definition of top-heavy plan

A defined benefit plan is a top-heavy plan if more than 60 percent of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60 percent of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year ("the determination date").

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, under prior law, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the five-year period ending on the determination date.

Under prior law, an individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the five-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

Definition of key employee

Under prior law, a key employee is an employee who, during the plan year that ends on the determination date or any of the four preceding plan years, is: (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 (\$70,000 for 2001), (2) a five-percent owner of the employer, (3) a one-percent owner of the employer earning over \$150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit (\$35,000 for 2001) with the largest ownership interests in the

employer. A family ownership attribution rule applies to the determination of one-percent owner status, five-percent owner status, and largest ownership interest. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

Minimum benefit for non-key employees

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of: (1) two percent of compensation multiplied by the employee's years of service, or (2) 20 percent of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of: (1) three percent of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Under prior law, employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).⁸⁰

Top-heavy vesting

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules: (1) three-year cliff vesting, which provides for 100 percent vesting after three years of service; and (2) two-six year graduated vesting, which provides for 20 percent vesting after two years of service, and 20 percent more each year thereafter so that a participant is fully vested after six years of service.⁸¹

Qualified cash or deferred arrangements

Under a qualified cash or deferred arrangement (a "section 401(k) plan"), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral per-

⁸⁰Treas. Reg. sec. 1.416-1 Q&A M-19.

⁸¹Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules: (1) five-year cliff vesting; and (2) three-seven year graded vesting, which provides for 20 percent vesting after three years and 20 percent more each year thereafter so that a participant is fully vested after seven years of service.

centage test or the “ADP” test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the “ACP” test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either: (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee’s compensation on behalf of each non-highly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (section 401(1)). A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee’s elective deferrals up to three percent of compensation and (b) 50 percent of the employee’s elective deferrals from three to five percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

Reasons for Change

The top-heavy rules primarily affect the plans of small employers. While the top-heavy rules were intended to provide additional minimum benefits to rank-and-file employees, the Congress was concerned that in some cases the top-heavy rules may act as a deterrent to the establishment of a plan by a small employer. The Congress believed that simplification of the top-heavy rules would help alleviate the additional administrative burdens the rules place on small employers. The Congress also believed that, in applying the top-heavy minimum benefit rules, the employer should receive credit for all contributions the employer makes, including matching contributions.

The Congress understood that some employers may have been discouraged from adopting a safe harbor section 401(k) plan due to concerns about the top-heavy rules. The Congress believed that facilitating the adoption of such plans would broaden coverage. Thus, the Congress believed it appropriate to provide that such plans are not subject to the top-heavy rules.

Explanation of Provision

Definition of top-heavy plan

EGTRRA provides that a plan consisting of a cash-or-deferred arrangement that satisfies the design-based safe harbor for such plans and matching contributions that satisfy the safe harbor rule for such contributions is not a top-heavy plan. Matching or nonelec-

tive contributions provided under such a plan may be taken into account in satisfying the minimum contribution requirements applicable to top-heavy plans.⁸²

In determining whether a plan is top-heavy, distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law five-year rule applies with respect to in-service distributions.⁸³ Similarly, EGTRRA provides that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the one-year period ending on the date the top-heavy determination is being made.

Definition of key employee

Under EGTRRA, an employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of \$130,000 (adjusted for inflation in \$5,000 increments), (2) a five-percent owner, or (3) a one-percent owner with compensation in excess of \$150,000. EGTRRA repeals the four-year lookback rule for determining key employee status and provides that an employee is a key employee only if he or she is a key employee during the preceding plan year. The present and prior-law limits on the number of officers treated as key employees under (1) continue to apply.

Minimum benefit for nonkey employees

Under EGTRRA, matching contributions are taken into account in determining whether the minimum benefit requirement has been satisfied.⁸⁴ In addition, in determining the minimum benefit required under a defined benefit plan, a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under section 410).

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$4 million in 2002, \$8 million in 2003, \$10 million in 2004, \$11 million in 2005, \$13 million in 2006, \$14 million in 2007, \$16 million in 2008, \$17 million in 2009, \$19 million in 2010, \$10 million in 2011, and \$5 million in 2012.

⁸²This provision is not intended to preclude the use of nonelective contributions that are used to satisfy the safe harbor rules from being used to satisfy other qualified retirement plan nondiscrimination rules, including those involving cross-testing.

⁸³A technical correction was enacted in Section 411(k) of the Job Creation and Worker Assistance Act of 2002 described in Part Eight of this document, that clarified that distributions made after severance from employment (rather than separation from service) are taken into account for only one year in determining top-heavy status.

⁸⁴Thus, this provision overrides the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

(d) Elective deferrals not taken into account for purposes of deduction limits (sec. 614 of the Act and sec. 404 of the Code)

Present and Prior Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.⁸⁵

In some cases, the amount of deductible contributions is limited by compensation. Under prior law, in the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.⁸⁶

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of: (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

Reasons for Change

Subjecting elective deferrals to the normally applicable deduction limits may cause employers to restrict the amount of elective deferrals an employee may make or to restrict employer contributions to the plan, thereby reducing participants' ultimate retirement benefits and their ability to save adequately for retirement. The Congress believed that the amount of elective deferrals otherwise allowable should not be further limited through application of the deduction rules.

Explanation of Provision

Under EGTRRA, elective deferral contributions are not subject to the deduction limits, and the application of a deduction limitation

⁸⁵ Section 652 of EGTRRA extends this rule to other defined benefit plans.

⁸⁶ Section 616 of EGTRRA increases this deduction limit to 25 percent of compensation.

to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.⁸⁷

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$47 million in 2002, \$88 million in 2003, \$103 million in 2004, \$111 million in 2005, \$119 million in 2006, \$127 million in 2007, \$135 million in 2008, \$144 million in 2009, \$152 million in 2010, \$103 million in 2011, and \$50 million in 2012.

- (e) Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations (sec. 615 of the Act and sec. 457 of the Code)**

Present and Prior Law

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local government employer (a “section 457 plan”) is not includible in gross income until paid or made available. Under prior law, the maximum permitted annual deferral under such a plan is generally the lesser of: (1) \$8,500 (in 2001) or (2) 33 $\frac{1}{3}$ percent of compensation. The \$8,500 limit is increased for inflation in \$500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant’s last three years before retirement, the otherwise applicable limit is increased to the lesser of: (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Under prior law, the \$8,500 limit (as modified under the catch-up rule) applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the \$8,500 limit, contributions under a tax-sheltered annuity (“section 403(b) annuity”), elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), salary reduction contributions under a simplified employee pension plan (“SEP”), and contributions under a SIMPLE plan are taken into account under prior law. Further, under prior law, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

Reasons for Change

The Congress believed that individuals participating in a section 457 plan should also be able to fully participate in a section 403(b)

⁸⁷ A technical correction was enacted in Section 411(l) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to provide a clarification that the provision applies also to elective deferrals to a SEP and that the combined deduction limit of 25 percent of compensation for qualified defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

annuity or section 401(k) plan of the employer. Eliminating the coordination rule may also encourage the establishment of section 403(b) or 401(k) plans by tax-exempt and governmental employers (to the extent permitted under present and prior law).

Explanation of Provision

The provision repeals the rules coordinating the section 457 dollar limit with contributions under other types of plans.⁸⁸

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$16 million in 2002, \$27 million annually in 2003 and 2004, \$25 million in 2005, \$23 million in 2006, \$24 million annually in 2007 through 2010, \$14 million in 2011, and \$7 million in 2012.

(f) Deduction limits (sec. 616 of the Act and sec. 404 of the Code)

Present and Prior Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.⁸⁹

In some cases, the amount of deductible contributions is limited by compensation. Under prior law, in the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of: (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

⁸⁸The limits on deferrals under a section 457 plan are modified under sections 611, 631, and 632 of EGTRRA, above.

⁸⁹Section 652 of EGTRRA extends this rule to other defined benefit plans.

In the case of an employee stock ownership plan (“ESOP”), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25 percent of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement (“section 401(k) plan”) are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.⁹⁰

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer’s contribution.⁹¹ An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefitting under the arrangement even if the employee elects not to defer.⁹²

Under prior law, for purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity (“section 403(b) annuity”), elective contributions under a deferred compensation plan of a tax-exempt organization or a State or local government (“section 457 plan”), and salary reduction contributions under a section 125 cafeteria plan. Under present and prior law, for purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

Reasons for Change

The Congress believed that compensation unreduced by employee elective contributions is a more appropriate measure of compensation for qualified retirement plan purposes, including deduction limits, than the prior-law rule. Applying the same definition for deduction purposes as is generally used for other plan purposes also simplifies application of the qualified plan rules. The Congress also believed that the 15-percent of compensation limit might restrict the amount of employer contributions to the plan, thereby reducing participants’ ultimate retirement benefits and their ability to adequately save for retirement.

Explanation of Provision

Under EGTRRA, the definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under section 415. In addition, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15 percent to 25 percent of compensation of the employees covered by the plan for the year.⁹³ Also, except to the extent provided in regulations, a money purchase

⁹⁰ Section 614 of EGTRRA, above, provides that elective deferrals are not subject to the deduction limits.

⁹¹ Rev. Rul. 65–295, 1965–2 C.B. 148.

⁹² Treas. Reg. sec. 1.410(b)–3.

⁹³ A technical correction was enacted in Section 411(l) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, that made a conforming change to a rule that limits the amount of deductible SEP contributions that may be made for a particular employee.

pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$8 million in 2002, \$17 million in 2003, \$19 million in 2004, \$21 million in 2005, \$22 million in 2006, \$25 million in 2007, \$27 million in 2008, \$28 million in 2009, \$30 million in 2010, \$16 million in 2011, \$7 million in 2012.

(g) Option to treat elective deferrals as after-tax contributions (sec. 617 of the Act and new sec. 402A of the Code)

Present and Law

A qualified cash or deferred arrangement (“section 401(k) plan”) or a tax-sheltered annuity (“section 403(b) annuity”) may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (section 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant’s gross income until distributed from the plan.

Elective deferrals for a taxable year that exceed the annual dollar limitation (“excess deferrals”) are includible in gross income for the taxable year. If an employee makes elective deferrals under a plan (or plans) of a single employer that exceed the annual dollar limitation (“excess deferrals”), then the plan may provide for the distribution of the excess deferrals, with earnings thereon. If the excess deferrals are made to more than one plan of unrelated employers, then the plan may permit the individual to allocate excess deferrals among the various plans, no later than the March 1 (April 15 under the applicable regulations) following the end of the taxable year. If excess deferrals are distributed not later than April 15 following the end of the taxable year, along with earnings attributable to the excess deferrals, then the excess deferrals are not again includible in income when distributed. The earnings are includible in income in the year distributed. If excess deferrals (and income thereon) are not distributed by the applicable April 15, then the excess deferrals (and income thereon) are includible in income when received by the participant. Thus, excess deferrals that are not distributed by the applicable April 15th are taxable both in the taxable year when the deferral was made and in the year the participant receives a distribution of the excess deferral.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and

may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that: (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to \$10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).⁹⁴

Reasons for Change

The Roth IRA provisions enacted in 1997 provided individuals with another form of tax-favored retirement savings. For a variety of reasons, some individuals may prefer to save through a Roth IRA rather than a traditional deductible IRA. The Congress believed that similar savings choices should be available to participants in section 401(k) plans and tax-sheltered annuities.

Explanation of Provision

A section 401(k) plan or a section 403(b) annuity is permitted to include a “qualified Roth contribution program” that permits a participant to elect to have all or a portion of the participant’s elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe)⁹⁵ as not excludable from the participant’s gross income.

The annual dollar limitation on a participant’s designated Roth contributions is the section 402(g) annual limitation on elective deferrals, reduced by the participant’s elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions.⁹⁶ Under a section 401(k) plan, designated Roth contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements.⁹⁷

The plan is required to establish a separate account (a “designated Roth contribution account”), and maintain separate record-

⁹⁴ Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

⁹⁵ It is intended that the Secretary generally will not permit retroactive designations of elective deferrals as designated Roth contributions.

⁹⁶ Similarly, designated Roth contributions to a section 403(b) annuity are treated the same as other salary reduction contributions to the annuity (except that designated Roth contributions are includible in income).

⁹⁷ It is intended that the Secretary provide ordering rules regarding the return of excess contributions under the special nondiscrimination rules (pursuant to sec. 401(k)(8)) in the event a participant makes both regular elective deferrals and designated Roth contributions. It is intended that such rules will generally permit a plan to allow participants to designate which contributions are returned first or to permit the plan to specify which contributions are returned first. It is also intended that the Secretary will provide ordering rules to determine the extent to which a distribution consists of excess Roth contributions.

keeping, for a participant's designated Roth contributions (and earnings allocable thereto). A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is: (1) made on or after the date on which the participant attains age 59½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.⁹⁸ The nonexclusion period is the five-year-taxable period beginning with the earlier of: (1) the first taxable year for which the participant made a designated Roth contribution to any designated Roth contribution account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated Roth contribution account that is the source of the distribution from a designated Roth contribution account established for the participant under another plan, the first taxable year for which the participant made a designated Roth contribution to the previously established account.

A distribution from a designated Roth contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution under the special nondiscrimination rules (pursuant to section 401(k)(8) (and income allocable thereto) is not a qualified distribution. In addition, the treatment of excess designated Roth contributions is similar to the treatment of excess deferrals attributable to non-designated Roth contributions. If excess designated Roth contributions (including earnings thereon) are distributed no later than the April 15th following the taxable year, then the designated Roth contributions is not includible in gross income as a result of the distribution, because such contributions are includible in gross income when made. Earnings on such excess designated Roth contributions are treated the same as earnings on excess deferrals distributed no later than April 15th, i.e., they are includible in income when distributed. If excess designated Roth contributions are not distributed by the applicable April 15th, then such contributions (and earnings thereon) are taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15th, the contributions are includible in income in the year when made and again when distributed from the plan. Earnings on such contributions are taxable when received.

A participant is permitted to roll over a distribution from a designated Roth contributions account only to another designated Roth contributions account or a Roth IRA of the participant.

The Secretary of the Treasury is directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated Roth contributions to make such returns and reports regarding designated Roth contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

⁹⁸ A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a designated Roth contributions account.

Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by \$185 million in 2006, \$236 million in 2007, \$172 million in 2008, and \$90 million in 2009 and to reduce Federal fiscal year budget receipts by \$5 million in 2010, \$358 million in 2011, and \$365 million in 2012.

(h) Nonrefundable credit to certain individuals for elective deferrals and IRA contributions (sec. 618 of the Act and new sec. 25B of the Code)

Present and Prior Law

Present and prior law provides favorable tax treatment for a variety of retirement savings vehicles, including employer-sponsored retirement plans and individual retirement arrangements (“IRAs”).

Several different types of tax-favored employer-sponsored retirement plans exist, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions (“SEPs”), section 408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain cases, employees, contribute to the plan. Taxation of the contributions and earnings thereon is generally deferred until benefits are distributed from the plan to participants or their beneficiaries.⁹⁹ Contributions and benefits under tax-favored employer-sponsored retirement plans are subject to specific limitations.

Coverage and nondiscrimination rules also generally apply to tax-favored employer-sponsored retirement plans to ensure that plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

IRAs include both traditional IRAs and Roth IRAs. In general, an individual makes contributions to an IRA, and investment earnings on those contributions accumulate on a tax-deferred basis. Total annual IRA contributions per individual are limited to a dollar amount (or the compensation of the individual or the individual’s spouse, if smaller). Contributions to a traditional IRA may be deducted from gross income if an individual’s adjusted gross income (“AGI”) is below certain levels or the individual is not an active participant in certain employer-sponsored retirement plans. Contributions to a Roth IRA are not deductible from gross income, regardless of adjusted gross income. A distribution from a traditional IRA is includible in the individual’s gross income except to the extent of individual contributions made on a nondeductible basis. A qualified distribution from a Roth IRA is excludable from gross income.

⁹⁹In the case of after-tax employee contributions, only earnings are taxed upon withdrawal.

Taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59½ are subject to a 10-percent additional tax, unless an exception applies.

Reasons for Change

The Congress recognized that the rate of private savings in the United States is low; in particular many low- and middle-income individuals have inadequate savings or no savings at all. A key reason for these low levels of saving is that lower-income families are likely to be more budget constrained with competing needs such as food, clothing, shelter, and medical care taking a larger portion of their income. The Congress believed providing an additional tax incentive for low- and middle-income individuals will enhance their ability to save adequately for retirement.

Explanation of Provision

EGTRRA provides a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income (“AGI”) of the taxpayer. Only joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer’s return.

The credit is available with respect to elective contributions to a section 401(k) plan, section 403(b) annuity, or eligible deferred compensation arrangement of a State or local government (a “section 457 plan”), SIMPLE, or SEP, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The present and prior-law rules governing such contributions continue to apply.

The amount of any contribution eligible for the credit is reduced by distributions of taxable or after-tax amounts¹⁰⁰ received by the taxpayer and his or her spouse from any savings arrangement described above or any other qualified retirement plan 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 and prior to the due date for filing the taxpayer’s return for the year. In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether or not taxable.

The credit rates based on AGI are provided in Table 9, below.

¹⁰⁰A technical correction was enacted in Section 411(m) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify that the amount of contributions taken into account in determining the credit is reduced by the amount of contributions taken into account in determining the credit is reduced by the amount of a distribution that consists of after-tax contributions. Distributions that are rolled over to another retirement plan do not affect the credit.

Table 9.—Credit Rates Based on AGI

Joint filers	Heads of households	All other filers	Credit rate (percent)
\$0–\$30,000	\$0–\$22,500	\$0–\$15,000	50
\$30,000–\$32,500	\$22,500– \$24,375.	\$15,000– \$16,250.	20
\$32,500–\$50,000	\$24,375– \$37,500.	\$16,250– \$25,000.	10
Over \$50,000 ...	Over \$37,500 ...	Over \$25,000 ...	0

Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2007.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$1,036 million in 2002, \$2,096 million in 2003, \$1,963 million in 2004, \$1,856 million in 2005, \$1,746 million in 2006, \$920 million in 2007, \$102 million in 2008, \$91 million in 2009, \$89 million in 2010, \$86 million in 2011, and \$82 million in 2012.

(i) Small business tax credit for new retirement plan expenses (sec. 619 of the Act and new sec. 45E of the Code)***Present and Prior Law***

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business.

Reasons for Change

One of the reasons some small employers may not adopt a tax-favored retirement plan is the administrative costs associated with such plans. The Congress believed that providing a tax credit for certain administrative costs would reduce one of the barriers to retirement plan coverage.

Explanation of Provision

EGTRRA provides a nonrefundable income tax credit for 50 percent of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE plan, or simplified employee pension (“SEP”). The credit applies to 50 percent of the first \$1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in ex-

cess of \$5,000. In order for an employer to be eligible for the credit, the plan must cover at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees of the employer who have worked with the employer for at least three months.

The credit is a general business credit.¹⁰¹ The 50 percent of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50 percent of the qualifying expenses (and other expenses) are deductible to the extent permitted under present and prior law.

Effective Date

The provision is effective with respect to costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans first effective after such date.¹⁰²

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$3 million in 2002, \$12 million in 2003, \$21 million in 2004, \$29 million annually in 2005 through 2007, \$27 million in 2008, \$26 million in 2009, \$25 million in 2010, \$22 million in 2011, and \$8 million in 2012.

(j) Eliminate IRS user fees for certain determination letter requests regarding employer plans (sec. 620 of the Act)

Present and Prior Law

An employer that maintains a retirement plan for the benefit of its employees may request from the IRS a determination as to whether the form of the plan satisfies the requirements applicable to tax-qualified plans (section 401(a)). In order to obtain from the IRS a determination letter on the qualified status of the plan, the employer must pay a user fee. The Secretary determines the user fee applicable for various types of requests, subject to statutory minimum requirements for average fees based on the category of the request. The user fee may range from \$125 to \$1,250, depending upon the scope of the request and the type and format of the plan.¹⁰³

Present and prior law provides that plans that do not meet the qualification requirements will be treated as meeting such requirements if appropriate retroactive plan amendments are made during the remedial amendment period. In general, the remedial amendment period ends on the due date for the employer's tax return (in-

¹⁰¹ The credit cannot be carried back to years before the effective date.

¹⁰² A technical correction was enacted in Section 411(n) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify that the credit is available if a plan is first effective after December 31, 2001, even if adopted on or before that date.

¹⁰³ Authorization for the user fees was originally enacted in section 10511 of the Revenue Act of 1987 (Pub. L. No. 100-203, December 22, 1987). The authorization was extended through September 30, 2003, by Pub. L. No. 104-117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)).

cluding extensions) for the taxable year in which the event giving rise to the disqualifying provision occurred (e.g., a plan amendment or a change in the law). The Secretary may provide for general extensions of the remedial amendment period or for extensions in certain cases. For example, the remedial amendment period with respect to amendments relating to the qualification requirements affected by the General Agreements on Tariffs and Trade, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the Internal Revenue Service Restructuring and Reform Act of 1998 generally ends on the later of February 28, 2002, or the last day of the first plan year beginning on or after January 1, 2001.¹⁰⁴

Reasons for Change

One of the factors affecting the decision of a small employer to adopt a plan is the level of administrative costs associated with the plan. The Congress believed that reducing administrative costs, such as IRS user fees, would help further the establishment of qualified plans by small employers.

Explanation of Provision

An eligible employer is not required to pay a user fee for a determination letter request with respect to the qualified status of a retirement plan that the employer maintains if the request is made before the later of: (1) the last day of the fifth plan year of the plan or (2) the end of any applicable remedial amendment period with respect to the plan that begins before the end of the fifth plan year of the plan. In addition, determination letter requests for which user fees are not required under the provision are not taken into account in determining average user fees. An employer is eligible under the provision if the employer has no more than 100 employees and has at least one nonhighly compensated employee who is participating in the plan. The provision applies only to requests by employers for determination letters concerning the qualified retirement plans they maintain. Therefore, a sponsor of a prototype plan is required to pay a user fee for a request for a notification letter, opinion letter, or similar ruling. A small employer that adopts a prototype plan, however, is not required to pay a user fee for a determination letter request with respect to the employer's plan.

Effective Date

The provision is effective for determination letter requests made after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$7 million in 2002 and \$10 million in 2003.

¹⁰⁴Rev. Proc. 2001-55, 2001-2 C.B. 552.

(k) Certain nonresident aliens excluded in applying minimum coverage requirements (sec. 621 of the Act and secs. 410(b)(3) and 861(a)(3) of the Code)

Present and Prior Law

Under the minimum coverage requirements (section 410(b)), a qualified plan must benefit a minimum number of the employer's nonhighly compensated employees. In applying the minimum coverage requirements, employees who are nonresident aliens are disregarded if they have no earned income from sources within the United States ("U.S. source income").

Generally, compensation for services performed in the United States is treated as U.S. source income. Under a special rule, compensation is not treated as U.S. source income if the compensation is paid for labor or services performed by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States. However, under prior law, this special rule does not apply for purposes of qualified retirement plans (including the minimum coverage and nondiscrimination requirements applicable to such plans), employer-provided group-term life insurance, or employer-provided accident and health plans. As a result, such compensation is treated as U.S. source income for purposes of such plans, including the application of the qualified retirement plan minimum coverage and nondiscrimination requirements. As a result, such nonresident aliens must be taken into account in determining whether the plan satisfies the minimum coverage requirements.

Reasons for Change

The Congress believed that nonresident aliens who are in the United States temporarily as crew members of foreign vessels engaged in transportation between the United States and a foreign country or a possession of the United States and who otherwise have no U.S. source income for Federal tax purposes should be disregarded in applying the nondiscrimination and other requirements applicable to employee benefit plans.

Explanation of Provision

Under EGTRRA, the special rule relating to compensation paid for labor or services performed by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States compensation is extended in order to apply for purposes of qualified retirement plans, employer-provided group-term life insurance, and employer-provided accident and health plans. Therefore, such compensation is not treated as U.S. source income for any purpose under such plans, including the application of the qualified retirement plan minimum coverage and nondiscrimination requirements.

Effective Date

The provision is effective with respect to plan years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$2 million in 2002, \$7 million annually in 2003 through 2005, \$8 million annually in 2006 through 2010, and \$5 million in 2011.

2. Enhancing fairness for women**(a) Additional salary reduction catch-up contributions
(sec. 631 of the Act and sec. 414 of the Code)*****Present and Prior Law******Elective deferral limitations***

Under present and prior law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

Under prior law, the maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a “401(k) plan”), a tax-sheltered annuity (“section 403(b) annuity”) or a salary reduction simplified employee pension plan (“SEP”) is \$10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,500 (for 2001). These limits are indexed for inflation in \$500 increments.

Section 457 plans

Under prior law, the maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a “section 457 plan”) is the lesser of: (1) \$8,500 (for 2001) or (2) 33 $\frac{1}{3}$ percent of compensation. The \$8,500 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant’s last three years before retirement, the otherwise applicable limit is increased to the lesser of: (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Reasons for Change

Although the Congress believes that individuals should be saving for retirement throughout their working lives, as a practical matter, many individuals simply do not focus on the amount of retirement savings they need until they near retirement. In addition, many individuals may have difficulty saving more in earlier years, e.g., because an employee leaves the workplace to care for a family. Some individuals may have a greater ability to save as they near retirement.

The Congress believes that the pension laws should assist individuals who are nearing retirement to save more for their retirement.

Explanation of Provision¹⁰⁵

EGTRRA provides that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, SEP, or SIMPLE, or deferrals under a governmental section 457 plan is increased to allow additional elective deferrals (“catch-up contributions”) for individuals who will attain age 50 by the end of the taxable year.¹⁰⁶ The catch-up contribution provision does not apply to after-tax employee contributions or to contributions to a defined benefit plan.

Catch-up contributions may be made by an individual who will attain age 50 by the end of the taxable year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under EGTRRA, the additional amount of elective contributions that may be made by an eligible individual participating in such a plan is the lesser of: (1) the applicable dollar amount or (2) the participant’s compensation for the year reduced by any other elective deferrals of the participant for the year.¹⁰⁷ The applicable dollar amount under a section 401(k) plan, section 403(b) annuity, SEP, or section 457 plan is \$1,000 for 2002, \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006 and thereafter. The applicable dollar amount under a SIMPLE is \$500 for 2002, \$1,000 for 2003, \$1,500 for 2004, \$2,000 for 2005, and \$2,500 for 2006 and thereafter. The \$5,000 and \$2,500 amounts are adjusted for inflation in \$500 increments in 2007 and thereafter.

A plan may not permit catch-up contributions in excess of the applicable limit. For this purpose, the limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan. The limit applies also to all section 457 plans of a government employer on an aggregated basis.

Catch-up contributions up to the specified limit are excluded from an individual’s income. The total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up contribution limit for that year and for that type of plan (e.g., a qualified retirement plan or a section 457 plan), without regard to whether the individual made catch-up contributions under plans maintained by more than one employer.

Catch-up contributions made under the provision are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules. However, a plan fails to meet the applicable nondiscrimination requirements

¹⁰⁵ Technical corrections were enacted in section 411(o) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify this EGTRRA provision.

¹⁰⁶ Section 611 of EGTRRA increases the dollar limit on elective deferrals under such arrangements.

¹⁰⁷ In the case of a section 457 plan, a participant may make catch-up contributions in an amount equal to the greater of the amount permitted under the new catch-up rule and the amount permitted under the special catch-up rule for such a plan.

under section 401(a)(4) with respect to benefits, rights, and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this rule, all plans of related employers are treated as a single plan. In addition, the special nondiscrimination rule for mergers and acquisitions applies for this purpose.

An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

The following examples illustrate the application of the provision, after the catch-up is fully phased-in.

Example 1: Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the provision) is \$15,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is \$8,000. Under the provision, A is able to make additional catch-up salary reduction contributions of \$5,000.

Example 2: Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is \$30,000. The maximum annual deferral limit (without regard to the provision) is \$15,000. Under the terms of the plan, the maximum permitted deferral is 10 percent of compensation or, in B's case, \$3,000. Under the provision, B can contribute up to \$8,000 for the year (\$3,000 under the normal operation of the plan, and an additional \$5,000 under the provision).

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$124 million in 2002, \$243 million in 2003, \$234 million in 2004, \$164 million in 2005, \$100 million in 2006, \$84 million in 2007, \$76 million in 2008, \$63 million in 2009, \$57 million in 2010, \$38 million in 2011, and \$18 million in 2012.

(b) Equitable treatment for contributions of employees to defined contribution plans (sec. 632 of the Act and secs. 403(b), 415, and 457 of the Code)

Present and Prior Law

Present and prior law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

Under prior law, in the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of \$35,000 (for 2001) or 25 percent of the employee's compensation (section 415(c)). Annual additions include employer contributions, including contribu-

tions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities

Under prior law, in the case of a tax-sheltered annuity (a “section 403(b) annuity”), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20 percent of the employee’s includible compensation, multiplied by the employee’s years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25 percent of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25 percent of the participant’s includible compensation; or (3) \$15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in a section 403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

Section 457 plans

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local governmental employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, under prior law, the maximum permitted annual deferral under such a plan is the lesser of: (1) \$8,500 (in 2001) or (2) 33 $\frac{1}{3}$ percent of compensation. The \$8,500 limit is increased for inflation in \$500 increments.

Reasons for Change

The Congress believes that the prior-law rules that limited contributions to defined contribution plans by a percentage of compensation reduced the amount that lower- and middle-income workers can save for retirement. The prior-law limits might not allow such workers to accumulate adequate retirement benefits, particularly if a defined contribution plan is the only type of retirement plan maintained by the employer.

Conforming the contribution limits for tax-sheltered annuities to the limits applicable to retirement plans simplifies the administration of the pension laws, and provides more equitable treatment for participants in similar types of plans.

Explanation of Provision**Increase in defined contribution plan limit**

EGTRRA increases the 25 percent of compensation limitation on annual additions under a defined contribution plan to 100 percent.¹⁰⁸ With respect to the increase in the defined contribution plan limit, it is intended that the Secretary of the Treasury will use the Secretary’s existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the average deferral percentage of nonhighly compensated employees.

Conforming limits on tax-sheltered annuities

EGTRRA repeals the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities are subject to the limits applicable to tax-qualified plans.¹⁰⁹

For taxable years beginning after December 31, 1999, a plan may disregard the regulations requirement under section 403(b) that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance.

Section 457 plans

EGTRRA increases the 33 $\frac{1}{3}$ percent of compensation limitation on deferrals under a section 457 plan to 100 percent of compensation.¹¹⁰

¹⁰⁸ Section 611 of EGTRRA increases the defined contribution plan dollar limit.

¹⁰⁹ A technical correction was enacted in section 411(p) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, clarifying the operation of this provision and restoring special rules for ministers and lay employees of churches and for foreign missionaries that were inadvertently eliminated by the EGTRRA provision.

¹¹⁰ A technical correction was enacted in section 411(p) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, that conformed the definition of com-

Effective Date

The provision is generally effective for years beginning after December 31, 2001. The provision regarding the regulations under section 403(b) is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$45 million in 2002, \$84 million in 2003, \$98 million in 2004, \$106 million in 2005, \$113 million in 2006, \$121 million in 2007, \$129 million in 2008, \$136 million in 2009, \$144 million in 2010, \$75 million in 2011, and \$36 million in 2012.

(c) Faster vesting of employer matching contributions (sec. 633 of the Act and sec. 411 of the Code)***Present and Prior Law***

Under present and prior law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.¹¹¹

Reasons for Change

The Congress understood that many employees, particularly lower- and middle-income employees, do not take full advantage of the retirement savings opportunities provided by their employer's section 401(k) plan. The Congress believed that providing faster vesting for matching contributions will make section 401(k) plans more attractive for employees, particularly lower- and middle-income employees, and would encourage employees to save more for their own retirement. In addition, faster vesting for matching contributions enables short-service employees to accumulate greater retirement savings.

Explanation of Provision

EGTRRA applies faster vesting schedules to employer matching contributions. Under EGTRRA, employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule

pensation used in applying this limit to a section 457 plan to the definition used for qualified defined contribution plans.

¹¹¹The minimum vesting requirements are also contained in Title I of ERISA.

if a participant has a nonforfeitable right to 20 percent of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service.

Effective Date

The provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(d) Modifications to minimum distribution rules (sec. 634 of the Act and sec. 401(a)(9) of the Code)

Present and Prior Law

In general

Minimum distribution rules apply to all types of tax-favored retirement arrangements, including qualified retirement plans and annuities, individual retirement arrangements ("IRAs"), tax-sheltered annuity plans ("section 403(b) plans"), and eligible deferred compensation plans of tax-exempt and State and local government employers ("section 457 plans"). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the individual plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived if the individual establishes to the satisfaction of the Secretary of the Treasury that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under Treasury regulations.

Distributions prior to the death of the individual

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either: (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are: (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In cal-

culating minimum required distributions from account-type arrangements (e.g., a defined contribution plan or an individual retirement account), life expectancies of the participant and the participant's spouse generally may be recomputed annually.

In the case of qualified retirement plans and annuities, section 403(b) plans, and section 457 plans, the required beginning date generally is April 1 of the calendar year following the later of (1) the calendar year in which the participant attains age 70½ or (2) the calendar year in which the participant retires. However, in the case of a five-percent owner of the employer, distributions generally are required to begin no later than April 1 of the calendar year following the year in which the five-percent owner attains age 70½. If commencement of distributions from a defined benefit plan is delayed beyond age 70½ (i.e., in the case of a participant who has not retired), then the accrued benefit of the participant must be actuarially increased to take into account the period after age 70½ in which the participant was not receiving benefits under the plan.¹¹² In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 of the calendar year following the calendar year in which the IRA owner attains age 70½. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under Treasury regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution is determined by dividing the employee's benefit by an amount from the uniform table provided in the regulations.

Distributions after the death of the plan participant

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if the participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the participant's death. The five-year rule does not apply if distributions begin within one year of the participant's death and are payable over the life of a designated beneficiary or over the life expectancy of a designated beneficiary. A surviving spouse beneficiary is not required to begin distribution until the date the deceased participant would have attained age 70½.

¹¹² State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70½.

Reasons for Change

For many years, the minimum distribution rules have been among the most complex of the rules relating to tax-favored arrangements. On January 17, 2001, the Secretary of the Treasury issued revised proposed regulations relating to the minimum distribution rules. The Congress believed that the implementation of these revised proposed regulations, along with additional statutory modifications of the minimum distribution rules, would result in significant simplification for individuals and plan administrators.

Explanation of Provision

EGTRRA directs the Treasury to revise the life expectancy tables under the applicable regulations to reflect current life expectancy.¹¹³

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than \$500,000 in 2002, \$1 million annually in 2003 and 2004, \$2 million annually in 2005 through 2009, \$3 million annually in 2010 and 2011, and \$1 million in 2012.

(e) Clarification of tax treatment of division of section 457 plan benefits upon divorce (sec. 635 of the Act and secs. 414(p) and 457 of the Code)

Present and Prior Law

Under present and prior law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order (“QDRO”). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present and prior law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

Under present and prior law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed

¹¹³The Secretary of the Treasury issued final regulations, including revised life expectancy tables, on April 17, 2002.

pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan (“section 457 plan”) of a tax-exempt or State and local government employer. Under prior law, the QDRO rules do not apply to section 457 plans.

Reasons for Change

The Congress believed that the rules regarding qualified domestic relations orders should apply to all types of employer-sponsored retirement plans.

Explanation of Provision

EGTRRA applies the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan does not violate the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. The special rule applicable to governmental plans and church plans applies for purposes of determining whether a distribution is pursuant to a QDRO.

Effective Date

The provision relating to tax treatment of distributions made pursuant to a domestic relations order from a section 457 plan is effective for transfers, distributions, and payments made after December 31, 2001.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(f) Provisions relating to hardship withdrawals (sec. 636 of the Act and secs. 401(k) and 402 of the Code)

Present and Prior Law

Elective deferrals under a qualified cash or deferred arrangement (a “section 401(k) plan”) may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations¹¹⁴ provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained

¹¹⁴Treas. Reg. sec. 1.401(k)-1.

by the employer for at least 12 months after receipt of the hardship distribution.

Under present and prior law, hardship withdrawals of elective deferrals from a qualified cash or deferred arrangement (or 403(b) annuity) are not eligible rollover distributions. Other types of hardship distributions, e.g., employer matching contributions distributed on account of hardship, are eligible rollover distributions. Different withholding rules apply to distributions that are eligible rollover distributions and to distributions that are not eligible rollover distributions. Eligible rollover distributions that are not directly rolled over are subject to withholding at a flat rate of 20 percent. Distributions that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10 percent. In either case, the individual may elect not to have withholding apply.

Reasons for Change

Although the Congress believed that it is appropriate to restrict the circumstances in which an in-service distribution from a 401(k) plan is permitted and to encourage participants to take such distributions only when necessary to satisfy an immediate and heavy financial need, the Congress was concerned about the impact of a 12-month suspension of contributions on the retirement savings of a participant who experiences a hardship. The Congress believed that the combination of a six-month contribution suspension and the other elements of the regulatory safe harbor would provide an adequate incentive for a participant to seek sources of funds other than his or her 401(k) plan account balance in order to satisfy financial hardships.

The prior-law rules regarding the ability to rollover hardship distributions created administrative burdens for plan administrators and confusion on the part of plan participants. The Congress believed that providing a uniform rule for all hardship distributions would simplify application of the rollover rules.

Explanation of Provision

The Secretary of the Treasury is directed to revise the applicable regulations to reduce from 12 months to six months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy an immediate and heavy financial need. The revised regulations are to be effective for years beginning after December 31, 2001.

In addition, any distribution made upon hardship of an employee is not an eligible rollover distribution. Thus, such distributions may not be rolled over, and are subject to the withholding rules applicable to distributions that are not eligible rollover distributions. EGTRRA does not modify the rules under which hardship distributions may be made. For example, as under present and prior law, hardship distributions of qualified employer matching contributions are only permitted under the rules applicable to elective deferrals.

EGTRRA is intended to clarify that all assets distributed as a hardship withdrawal, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, are ineligible for rollover. This rule is intended to apply to all hardship distributions from any tax qualified plan, including those made pursuant to standards set forth in section 401(k)(2)(B)(i)(IV) (which are applicable to section 401(k) plans and section 403(b) annuities) and to those treated as hardship distributions under any profit-sharing plan (whether or not in accordance with the standards set forth in section 401(k)(2)(B)(i)(IV)). For this purpose, a distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed period of years) could be treated as made upon hardship of the employee if the plan treats it that way. For example, if a plan makes an in-service distribution that consists of assets attributable to both elective deferrals (in circumstances where those assets could be distributed only upon hardship) and employer matching or nonelective contributions (which could be distributed in nonhardship circumstances under the plan), the plan is permitted to treat the distribution in its entirety as made upon hardship of the employee.

Effective Date

The provision directing the Secretary to revise the rules relating to safe harbor hardship distributions is effective on the date of enactment. The provision that hardship distributions are not eligible rollover distributions is effective for distributions made after December 31, 2001. The Secretary has the authority to issue transitional guidance with respect to the provision that hardship distributions are not eligible rollover distributions to provide sufficient time for plans to implement the new rule.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(g) Pension coverage for domestic and similar workers (sec. 637 of the Act and sec. 4972(c)(6) of the Code)

Present and Prior Law

Under present and prior law, within limits, employers may make deductible contributions to qualified retirement plans for employees. Subject to certain exceptions, a 10-percent excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for their employees. Contributions to such plans are not deductible because they are not made in connection with a trade or business of the employer.

Reasons for Change

Under prior law, individuals who employ domestic and similar workers could be discouraged from providing pension plan coverage for such employees because of the possible adverse tax consequences from making nondeductible contributions. As a result, such workers, who are typically lower income, might be denied the opportunity for tax-favored retirement savings. The Congress believed that individuals who employ such workers should be encouraged to provide pension coverage.

Explanation of Provision

The 10-percent excise tax on nondeductible contributions does not apply to contributions to a SIMPLE plan or a SIMPLE IRA that are nondeductible solely because the contributions are not a trade or business expense under section 162 because they are not made in connection with a trade or business of the employer. Thus, for example, employers of household workers are able to make contributions to such plans without imposition of the excise tax.¹¹⁵ As under present and prior law, the contributions are not deductible. The present and prior-law rules applicable to such plans, e.g., contribution limits and nondiscrimination rules, continue to apply. EGTRRA does not apply with respect to contributions on behalf of the individual and members of his or her family.

No inference is intended with respect to the application of the excise tax under prior law to contributions that are not deductible because they are not made in connection with a trade or business of the employer.

As under present and prior law, a plan covering domestic workers is not qualified unless the coverage rules are satisfied by aggregating all employees of family members taken into account under the attribution rules in section 414(c), but disregarding employees employed by a controlled group of corporations or a trade or business.

It is intended that this exception to the 100 percent excise tax is restricted to contributions made by employers of household workers with respect to whom all applicable employment taxes have been and are being paid.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than \$500,000 annually in 2002 and 2003, \$1 million in 2004, \$2 million in 2005, \$4 million in 2006, \$6 million in 2007, \$8 million in 2008, \$10 million in 2009, \$12 million in 2010, \$14 million in 2011, and \$5 million 2012.

¹¹⁵Section 3(c) of the Tax Technical Corrections Act of 2002, introduced on November 13, 2002, as H.R. 5713 in the House of Representatives and S. 3153 in the Senate, would revise the definition of compensation for purposes of determining contributions to a SIMPLE plan or a SIMPLE IRA to include wages paid to household workers, even though such amounts are not subject to income tax withholding.

3. Increasing portability for participants

(a) Rollovers of retirement plan and IRA distributions (secs. 641–643 and 649 of the Act and secs. 401, 402, 403(b), 408, 457, and 3405 of the Code)

Present and Prior Law

In general

Present and prior law permit the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present and prior law, an “eligible rollover distribution” from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement (“IRA”)¹¹⁶ or another qualified plan.¹¹⁷ An “eligible rollover distribution” means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include: (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee’s designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. Under prior law, the maximum amount that could be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

Under prior law, eligible rollover distributions from a tax-sheltered annuity (“section 403(b) annuity”) could be rolled over only into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity could not be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

IRA distributions

Under prior law, distributions from a traditional IRA, other than minimum required distributions, could be rolled over into another traditional IRA.¹¹⁸ In general, distributions from an IRA could not be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called a traditional “conduit IRAs.” Under the conduit IRA rule, amounts can be rolled from a qualified plan into IRA and then subsequently rolled back

¹¹⁶A “traditional” IRA refers to IRAs other than Roth IRAs or SIMPLE IRAs.

¹¹⁷An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan.

¹¹⁸Distributions from a Roth IRA may be rolled over only to another Roth IRA.

to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to a traditional IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Distributions from section 457 plans

A “section 457 plan” is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Under prior law, section 457 benefits could be transferred only to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Rollovers by surviving spouses

Under prior law, a surviving spouse that receives an eligible rollover distribution could roll over the distribution into a traditional IRA, but not a qualified plan or section 403(b) annuity.

Direct rollovers and withholding requirements

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20-percent rate.¹¹⁹

Notice of eligible rollover distribution

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of: (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

¹¹⁹ Distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10 percent. In either case, the individual may elect not to have withholding apply.

Taxation of distributions

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received (except to the extent the amount received constitutes a return of after-tax contributions or a qualified distribution from a Roth IRA). In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Includible distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10-percent early withdrawal tax if made before age 59½. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10-percent early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10-percent early withdrawal tax does not apply to section 457 plans.

Reasons for Change

Present and prior law encourages individuals who receive distributions from qualified plans and similar arrangements to save those distributions for retirement by facilitating tax-free rollovers to an IRA or another qualified plan. The Congress believed that expanding the rollover options for individuals in employer-sponsored retirement plans and owners of IRAs would provide further incentives for individuals to continue to accumulate funds for retirement. The Congress believed it appropriate to extend the same rollover rules to governmental section 457 plans; like qualified plans, such plans are required to hold plan assets in trust for employees.

Explanation of Provision

In general

EGTRRA provides that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally can be rolled over to any of such plans or arrangements.¹²⁰ Similarly, distributions from a traditional IRA (or a Simple IRA in which the individual has participated for two years or more) generally are permitted to be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions.¹²¹ The rollover notice (with respect to all

¹²⁰ Under section 636 of EGTRRA, hardship distributions are not considered eligible rollover distributions.

¹²¹ The elective withholding rules applicable to distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are also extended to distributions from governmental section 457 plans. Thus, periodic distributions from governmental section

plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, section 403(b) annuities, and governmental section 457 plans may, but are not required to, accept rollovers.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under prior law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover would have to be made to a “conduit IRA” as under prior law, and then rolled back into a qualified plan. Amounts distributed from a governmental section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Governmental section 457 plans are required to separately account for such amounts.

Rollover of after-tax contributions

EGTRRA provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon).¹²²

After-tax contributions (including nondeductible contributions to a traditional IRA) are not permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan. In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

EGTRRA provides that surviving spouses may roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the surviving spouse participates.

Treasury regulations

The Secretary is directed to prescribe rules necessary to carry out these provisions. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, ex-

457 plans that are not eligible rollover distributions are subject to withholding as if the distribution were wages and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding at a 10-percent rate. In either case, the individual may elect not to have withholding apply.

¹²² A technical correction was enacted in section 411(q) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify that a qualified plan must provide for the direct rollover of after-tax contributions only to a qualified defined contribution plan or a traditional IRA and that, if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts.

pand Form 8606—Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date

The provision is effective for distributions made after December 31, 2001. It is intended that the Secretary will revise the safe harbor rollover notice that plans may use to satisfy the rollover requirements. No penalty is imposed on a plan for a failure to provide the information required under the provision with respect to any distribution made before the date that is 90 days after the date the Secretary issues a new safe harbor rollover notice, if the plan administrator makes a reasonable attempt to comply with such notice requirement.^{122A} For example, the provision requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making the distribution. A plan is treated as making a reasonable good faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences from those that apply to distributions from the plan from which the rollover is made.

Revenue Effect

The provisions are estimated to increase Federal fiscal year budget receipts by \$27 million in 2002, and to reduce Federal fiscal year budget receipts by \$4 million annually in 2003 and 2004, \$5 million annually in 2005 through 2007, \$6 million annually in 2008 and 2009, \$7 million in 2010, \$43 million in 2011, and \$3 million in 2012.

(b) Waiver of 60-day rule (sec. 644 of the Act and secs. 402 and 408 of the Code)

Present and Prior Law

Under present and prior law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. Under prior law, the Secretary does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The Secretary has issued regulations postponing the 60-day rule in such cases.

Reasons for Change

The inability of the Secretary to waive the 60-day rollover period may result in adverse tax consequences for individuals. The Congress believed such harsh results are inappropriate and that providing for waivers of the rule would help facilitate rollovers.

^{122A} Notice 2002-3, 2002-2 I.R.B. 289, provides a new safe harbor rollover notice.

Explanation of Provision

EGTRRA provides that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. For example, the Secretary may issue guidance that includes objective standards for a waiver of the 60-day rollover period, such as waiving the rule due to military service in a combat zone or during a Presidentially declared disaster (both of which are provided for under present and prior law), or for a period during which the participant has received payment in the form of a check, but has not cashed the check, or for errors committed by a financial institution, or in cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error.

Effective Date

The provision applies to distributions made after December 31, 2001.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(c) Treatment of forms of distribution (sec. 645 of the Act and sec. 411(d)(6) of the Code)

Present and Prior Law

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (section 411(d)(6)).¹²³

Under regulations issued by the Secretary,¹²⁴ this prohibition against the elimination of an optional form of benefit does not apply in the case of (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the participant receives at least 90 days' advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or a section 401(k) plan must be to a plan of the same type and that the transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status.

¹²³ A similar provision is contained in Title I of ERISA.

¹²⁴ Treas. Reg. sec. 1.411(d)-4, Q&A-2(e) and Q&A-(3)(b).

Reasons for Change

The Congress understood that the application of the prohibition against the elimination of any optional form of benefit frequently resulted in complexity and confusion, especially in the context of business acquisitions and similar transactions, and made it difficult for participants to understand their benefit options and make choices that are best-suited to their needs. The Congress believed that it appropriate to permit the elimination of duplicative benefit options that develop following plan mergers and similar events while ensuring that meaningful early retirement benefit payment options and subsidies may not be eliminated. In addition, the Congress understood that a defined contribution plan participant who is entitled to receive a single sum distribution generally may roll over such a distribution to an IRA and control the manner of distribution from the IRA, thus reducing the need to prohibit the elimination of all optional forms of benefits.

Explanation of Provision

A defined contribution plan to which benefits are transferred will not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if: (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution.

Except to the extent provided by the Secretary of the Treasury in regulations, a defined contribution plan is not treated as reducing a participant's accrued benefit if: (1) a plan amendment eliminates a form of distribution previously available under the plan, (2) a single sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment, and (3) the single sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution eliminated by the amendment.

Furthermore, the provision directs the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to plan amendments that eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in more than a de minimis manner.

It is intended that the factors to be considered in determining whether an amendment has more than a de minimis adverse effect on any participant will include: (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

This provision of EGTRRA does not affect the rules relating to involuntary cash outs (section 411(a)(11)) or survivor annuity requirements (section 417). Further, as under present and prior law, a plan that is a transferee of a plan subject to the joint and survivor rules is also subject to those rules. Accordingly, if a participant is entitled to protections of the joint and survivor rules, those protections may not be eliminated. The intent of the provision authorizing regulations is solely to permit the elimination of early retirement benefits, retirement-type subsidies, or optional forms of benefit that have no more than a de minimis effect on any participant but create disproportionate burdens and complexities for a plan and its participants.

For example, assume the following. Employer A acquires employer B and merges B's defined benefit plan into A's defined benefit plan. The defined benefit plan maintained by B before the merger provides an early retirement subsidy for individuals age 55 with a specified number of years of service. E1 and E2 are employees of B and who transfer to A in connection with the merger. E1 is 25 years old and has compensation of \$40,000. The present value of E1's early retirement subsidy under B's plan is \$75. E2 is 50 years old and also has compensation of \$40,000. The present value of E2's early retirement subsidy under B's plan is \$10,000.

Assume that A's plan has an early retirement subsidy for individuals who have attained age 50 with a specified number of years of service, but the subsidy is not the same as under B's plan. Under A's plan, the present value of E2's early retirement subsidy is \$9,850. Maintenance of both subsidies after the plan merger would create burdens for the plan and complexities for the plan and its participants.

Treasury regulations could permit E1's early retirement subsidy under B's plan to be eliminated entirely (i.e., even if A's plan did not have an early retirement subsidy). Taking into account all relevant factors, including the value of the benefit, E1's compensation, and the number of years until E1 would be eligible to receive the subsidy, the subsidy is de minimis. Treasury regulations could permit E2's early retirement subsidy under B's plan to be eliminated and to be replaced by the subsidy under A's plan, because the dif-

ference in the subsidies is de minimis. However, E2's subsidy could not be entirely eliminated.

The Secretary is directed to issue, not later than December 31, 2003, final regulations under section 411(d)(6), including regulations required under the provision.

Effective Date

The provision is effective for years beginning after December 31, 2001, except that the direction to the Secretary is effective on the date of enactment.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(d) Rationalization of restrictions on distributions (sec. 646 of the Act and secs. 401(k), 403(b), and 457 of the Code)

Present and Prior Law

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), tax-sheltered annuity ("section 403(b) annuity"), or an eligible deferred compensation plan of a tax-exempt organization or State or local government ("section 457 plan"), may not be distributable prior to the occurrence of one or more specified events. Under prior law, these permissible distributable events include "separation from service."

A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called "same desk rule," a participant's severance from employment does not necessarily result in a separation from service.¹²⁵

Under prior law, in addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but do not experience a separation from service because the employees continue on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary. Under a recent IRS ruling, a person is generally deemed to have separated from service if that person is transferred

¹²⁵ Rev. Rul. 79-336, 1979-2 C.B. 187.

to another employer in connection with a sale of less than substantially all the assets of a trade or business.¹²⁶

Reasons for Change

The Congress believed that application of the “same desk” rule was inappropriate because it hindered portability of retirement benefits, created confusion for employees, and resulted in significant administrative burdens for employers that engage in business acquisition transactions.

Explanation of Provision

EGTRRA modifies the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation’s disposition of its assets or a subsidiary are repealed; this special rule is no longer necessary under the provision.

It is intended that a plan may provide that certain specified types of severance from employment do not constitute distributable events. For example, a plan could provide that a severance from employment is not a distributable event if it would not have constituted a “separation from service” under the law in effect prior to a specified date. Also, if a plan describes distributable events by reference to section 401(k)(2), the plan may be amended to restrict distributable events to fewer than all events that constitute a severance from employment. Thus, for example, if a plan sponsor had employees who experienced a severance from employment in the past that the “same desk rule” prevented from being treated as a distributable event, the plan sponsor would have the option of providing in the plan that such severance from employment would, or would not, be treated as a distributable event under the plan.

It is intended that, as under present and prior law, if there is a transfer of plan assets and liabilities relating to any portion of an employee’s benefit under a plan of the employee’s former employer to a plan being maintained or created by the employee’s new employer (other than a rollover or elective transfer), then that employee has not experienced a severance from employment with the employer maintaining the plan that covers the employee.

Effective Date

The provision is effective for distributions after December 31, 2001, regardless of when the severance of employment occurred.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

¹²⁶ Rev. Rul. 2000-27, 2000-21 I.R.B. 1016.

(e) Purchase of service credit under governmental pension plans (sec. 647 of the Act and secs. 403(b) and 457 of the Code)

Present and Prior Law

A qualified retirement plan maintained by a State or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (section 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits.

Under prior law, a participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization or a State or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

Reasons for Change

The Congress understood that many employees work for multiple State or local government employers during their careers. The Congress believed that allowing such employees to use their section 403(b) annuity and governmental section 457 plan accounts to purchase permissive service credits or make repayments with respect to forfeitures of service credit would result in more significant retirement benefits for employees who would not otherwise be able to afford such credits or repayments.

Explanation of Provision

A participant in a State or local governmental plan is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a governmental section 457 plan if the transferred amount is used: (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State).

Effective Date

The provision is effective for transfers after December 31, 2001.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(f) Employers may disregard rollovers for purposes of cash-out rules (sec. 648 of the Act and sec. 411(a)(11) of the Code)***Present and Prior Law***

If an qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.¹²⁷

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.¹²⁸

Reasons for Change

The cash-out rule reflects a balancing of various policies. On the one hand is the desire to assist individuals to save for retirement by making it easier to keep retirement funds in tax-favored vehicles. On the other hand is the recognition that keeping track of small account balances of former employees creates administrative burdens for plans.

The Congress was concerned that, in some cases, the cash-out rule might discourage plans from accepting rollovers because the rollover would increase participants' benefits to above the cash-out amount, and increase administrative burdens. The Congress believed that disregarding rollovers for purposes of the cash-out rule would further the intent of the cash-out rule by removing a possible disincentive for plans to accept rollovers.

Explanation of Provision

For purposes of the cash-out rule, a plan is permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).¹²⁹

¹²⁷ A similar provision is contained in Title I of ERISA.

¹²⁸ Section 641 of EGTRRA expands the kinds of plans to which benefits may be rolled over.

¹²⁹ A technical correction was enacted in section 411(r) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify that rollover amounts may be disregarded also in determining whether a spouse must consent to the cash-out of the benefit.

Effective Date

The provision is effective for distributions after December 31, 2001.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(g) Minimum distribution and inclusion requirements for section 457 plans (sec. 649 of the Act and sec. 457 of the Code)***Present and Prior Law***

A “section 457 plan” is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. For example, amounts deferred under a section 457 plan cannot exceed certain limits. Under prior law, amounts deferred under a section 457 plan were generally includible in income when paid or made available. Under present and prior law, amounts deferred under a plan of deferred compensation of a State or local government or tax-exempt employer that does not meet the requirements of section 457 are includible in income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether the amounts have been paid or made available.¹³⁰

Section 457 plans are subject to the minimum distribution rules applicable to tax-qualified pension plans. In addition, under prior law, such plans were subject to additional minimum distribution rules (section 457(d)(2)(B)).

Reasons for Change

The Congress believed that the rules for timing of inclusion of benefits under a governmental section 457 plan should be conformed to the rules relating to qualified plans. The Congress also believed that section 457 plans should be subject to the same minimum distribution rules applicable to qualified plans.

Explanation of Provision

EGTRRA provides that amounts deferred under a section 457 plan of a State or local government are includible in income when paid. EGTRRA also repeals the special minimum distribution rules applicable to section 457 plans. Thus, such plans are subject to the minimum distribution rules applicable to qualified plans.

Effective Date

The provision is effective for distributions after December 31, 2001.

¹³⁰This rule of inclusion does not apply to amounts deferred under a tax-qualified retirement plan or similar plans.

Revenue Effect

The estimated revenue effect of this provision is considered in the estimated revenue effect of other provisions of Title VI of EGTRRA.

4. Strengthening pension security and enforcement

- (a) Phase in repeal of 160 percent of current liability funding limit; deduction for contributions to fund termination liability (secs. 651–652 of the Act and secs. 404(a)(1), 412(c)(7), and 4972(c) of the Code)**

Present and Prior Law

Under present and prior law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. Under prior law, the full funding limit is generally defined as the excess, if any, of: (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160 percent of the plan's current liability, over (2) the value of the plan's assets (section 412(c)(7)).¹³¹ In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. Under prior law, the current liability full funding limit is scheduled to increase as follows: 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.¹³² In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special prior-law rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Reasons for Change

The Congress was concerned that the current liability full funding limit, which focuses on current but not projected benefits, may result in inadequate funding of pension plans and thus jeopardize pension security. The Congress believed that repealing the current liability full funding limit will encourage responsible pension funding and help ensure that plan participants receive promised bene-

¹³¹ The minimum funding requirements, including the full funding limit, are also contained in title I of ERISA.

¹³² As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, 160 percent in 2001 and 2002, and adopted the scheduled increases described in the text.

fits. Also, the Congress believed that the special deduction rule should be expanded to give more plan sponsors incentives to adequately fund their plans.

Explanation of Provision

Current liability full funding limit

The provision gradually increases and then repeals the current liability full funding limit. Under the provision, the current liability full funding limit is 165 percent of current liability for plan years beginning in 2002, and 170 percent for plan years beginning in 2003. The current liability full funding limit is repealed for plan years beginning in 2004 and thereafter. Thus, in 2004 and thereafter, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets.

Deduction for contributions to fund termination liability

The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans, i.e., the special rule applies to multiemployer plans and plans with 100 or fewer participants. In the case of a plan with less than 100 participants for the plan year, unfunded current liability does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years.

The provision also amends the special rule by providing that, in the case of a plan that is covered by the Pension Benefit Guaranty Corporation ("PBGC") termination insurance program¹³³ and terminates within the plan year, the deduction is for up to 100 percent of unfunded termination liability.¹³⁴

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$14 million in 2002, \$20 million in 2003, \$36 million annually in 2004 and 2005, \$38 million annually in 2006 and 2007, \$39 million in 2008, \$41 million in 2009, \$42 million in 2010, \$22 million in 2011, and less than \$5 million in 2012.

¹³³ The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

¹³⁴ A technical correction was enacted in section 411(s) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify this provision.

(b) Excise tax relief for sound pension funding (sec. 653 of the Act and sec. 4972 of the Code)

Present and Prior Law

Under present and prior law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. Under prior law, the full funding limit is generally defined as the excess, if any, of: (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160 percent of the plan's current liability, over (2) the value of the plan's assets (section 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. Under prior law, the current liability full funding limit is scheduled to increase as follows: 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.¹³⁵ In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.¹³⁶

Present and prior law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year. The 10-percent excise tax does not apply to contributions to certain terminating defined benefit plans. The 10-percent excise tax also does not apply to contributions of up to six percent of compensation to a defined contribution plan for employer matching and employee elective deferrals.

Reasons for Change

The Congress believed that employers should be encouraged to adequately fund their pension plans. Therefore, the Congress did not believe that an excise tax should be imposed on employer contributions that do not exceed the accrued liability full funding limit.

¹³⁵As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, 160 percent in 2001 and 2002, and adopted the scheduled increases described in the text. Section 651 of EGTRRA gradually increases and then repeals the current liability full funding limit.

¹³⁶Section 652 of EGTRRA extends this special rule to other defined benefit plans.

Explanation of Provision

In determining the amount of nondeductible contributions, the employer is permitted to elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit are not subject to the excise tax on nondeductible contributions. An employer making such an election for a year is not permitted to take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans. EGTRRA applies to terminated plans as well as ongoing plans.

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$2 million in 2002, \$3 million annually in 2003 through 2011, and less than \$500,000 in 2012.

(c) Modifications to section 415 limits for multiemployer plans (sec. 654 of the Act and sec. 415 of the Code)

Present and Prior Law

Under present and prior law, limits apply to contributions and benefits under qualified plans (section 415). The limits on contributions and benefits under qualified plans depend on whether the plan is a defined benefit plan or a defined contribution plan.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of: (1) 100 percent of average compensation for the highest three years, or (2) a dollar amount (\$140,000 for 2001).¹³⁷ The dollar limit is adjusted for cost-of-living increases in \$5,000 increments.

In applying the limits on contributions and benefits, plans of the same employer are aggregated. That is, all defined benefit plans of the same employer are treated as a single plan, and all defined contribution plans of the same employer are treated as a single plan. Under Treasury regulations, multiemployer plans are not aggregated with other multiemployer plans. However, if an employer maintains both a plan that is not a multiemployer plan and a multiemployer plan, the plan that is not a multiemployer plan is aggregated with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided with respect to a common participant.¹³⁸

¹³⁷ Section 611 of EGTRRA increases the dollar limits on benefits for years after 2001.

¹³⁸ Treas. Reg. section 1.415-8(e).

Reasons for Change

The Congress understood that, because pension benefits under multiemployer plans are typically based upon factors other than compensation, the section 415 benefit limits frequently resulted in benefit reductions for employees in industries in which wages vary annually.

Explanation of Provision

Under EGTRRA, the 100 percent of compensation defined benefit plan limit does not apply to multiemployer plans. With respect to aggregation of multiemployer plans with other plans, EGTRRA provides that multiemployer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multiemployer plan for purposes of applying the 100 percent of compensation limit to such single-employer plan.

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$3 million in 2002, \$5 million annually in 2003 through 2006, \$6 million annually in 2007 through 2010, \$4 million in 2011, and less than \$500,000 in 2012.

(d) Investment of employee contributions in 401(k) plans (sec. 655 of the Act and sec. 1524(b) of the Taxpayer Relief Act of 1997)

Present and Prior Law

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”) prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10 percent of the fair market value of plan assets. The 10-percent limitation does not apply to any “eligible individual account plans” that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement (“401(k) plans”).

Under the Taxpayer Relief Act of 1997, the term “eligible individual account plan” does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than one percent of any employee’s eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10-percent limitation does not apply, as long

as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10 percent of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10 percent of the value of the assets of all pension plans maintained by the employer. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

Reasons for Change

The Congress believed that the effective date provided in the Taxpayer Relief Act of 1997 with respect to the rule excluding elective deferrals (and earnings thereon) from the definition of eligible individual account plan has produced unintended results.

Explanation of Provision

EGTRRA modifies the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of eligible individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired: (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

Effective Date

The provision is effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon) from the definition of eligible individual account plan.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

**(e) Prohibited allocations of stock in an S corporation
ESOP (sec. 656 of the Act and secs. 409 and 4979A
of the Code)**

Present and Prior Law

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present and prior law provides a deferral of income on the sales of certain employer securities to an ESOP (section 1042). A 50-percent excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

Reasons for Change

In enacting the 1996 Act provision allowing ESOPs to be shareholders of S corporations, the Congress intended to encourage employee ownership of closely-held businesses, and to facilitate the establishment of ESOPs by S corporations. At the same time, the Congress provided that all income flowing through to an ESOP (or other tax-exempt S shareholder), and gains and losses from the disposition of the stock, was treated as unrelated business taxable income. This treatment was consistent with the premise underlying the S corporation rules that all income of an S corporation (including all gains of the sale of the stock of the corporation) should be subject to a shareholder-level tax.

In enacting the present and prior-law rule relating to S corporation ESOPs in 1997, the Congress was concerned that the 1996 Act rule imposed double taxation on such ESOPs and ESOP participants. The Congress believed such a result was inappropriate. Since the enactment of the 1997 Act, however, the Congress became aware that the present-law rules allow inappropriate deferral and possibly tax avoidance in some cases.

The Congress continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Congress does not believe, however, that ESOPs should be used by S corporations owners to obtain inappropriate tax deferral or avoidance.

Specifically, the Congress believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

Explanation of Provision

In general

Under EGTRRA, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax is imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person.¹³⁹

It is intended that EGTRRA will limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

Definition of nonallocation year

A nonallocation year means any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50 percent of the number of outstanding shares of the S corporation.

A person is a disqualified person if the person is either: (1) a member of a “deemed 20-percent shareholder group” or (2) a “deemed 10-percent shareholder.” A person is a member of a “deemed 20-percent shareholder group” if the aggregate number of deemed-owned shares of the person and his or her family members is at least 20 percent of the number of deemed-owned shares of stock in the S corporation.¹⁴⁰ A person is a deemed 10-percent shareholder if the person is not a member of a deemed 20-percent shareholder group and the number of the person’s deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock of the corporation.

In general, “deemed-owned shares” means: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual’s share of unallocated stock held by the ESOP. An individual’s share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of stock under the terms of the plan.

For purposes of determining whether there is a nonallocation year, ownership of stock generally is attributed under the rules of section 318,¹⁴¹ except that: (1) the family attribution rules are modified to include certain other family members, as described below, (2) option attribution does not apply (but instead special rules relating to synthetic equity described below apply), and (3) “deemed-owned shares” held by the ESOP are treated as held by the individual with respect to whom they are deemed owned.

¹³⁹ The plan is not disqualified merely because an excise tax is imposed under the provision.

¹⁴⁰ A family member of a member of a “deemed 20-percent shareholder group” with deemed owned shares is also treated as a disqualified person.

¹⁴¹ These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity.

Under EGTRRA, family members of an individual include (1) the spouse¹⁴² of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

EGTRRA contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, stock on which a synthetic equity interest is based is treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment will result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

"Synthetic equity" means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.¹⁴³

Ownership of synthetic equity is attributed in the same manner as stock is attributed under the provision. In addition, ownership of synthetic equity is attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.

Definition of prohibited allocation

An ESOP of an S corporation is required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A "prohibited allocation" refers to violations of this provision. A prohibited allocation occurs, for example, if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person.

Application of excise tax

In the case of a prohibited allocation, the S corporation is liable for an excise tax equal to 50 percent of the amount of the allocation. For example, if S corporation stock is allocated in a prohibited allocation, the excise tax is equal to 50 percent of the fair market value of such stock.

A special rule applies in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year,

¹⁴²As under section 318, an individual's spouse is not treated as a member of the individual's family if the spouses are legally separated.

¹⁴³The provisions relating to synthetic equity do not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year.

As mentioned above, the S corporation also is liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax is 50 percent of the value of the shares on which synthetic equity is based.

Treasury regulations

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of the provision and to determine, by regulation or other guidance of general applicability, that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes, in substance, an avoidance or evasion of the prohibited allocation rules. For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.

Effective Date

The provision generally is effective with respect to plan years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after March 14, 2001.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by \$3 million in 2002, \$5 million in 2003, \$6 million in 2004, \$8 million annually in 2005 and 2006, \$9 million in 2007, \$10 million annually in 2008 through 2010, \$11 million in 2011, and less than \$500,000 in 2012.

(f) Automatic rollovers of certain mandatory distributions (sec. 657 of the Act and secs. 401(a)(31) and 402(f)(1) of the Code and sec. 404(c) of ERISA)

Present and Prior Law

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.¹⁴⁴ Before making a distribution that is eligible for rollover, a plan administrator must provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another qualified plan and the related tax consequences.

Reasons for Change

The Congress believed that prior law did not adequately encourage rollovers of involuntary distribution amounts. Failure to roll over these amounts can significantly reduce the retirement income that would otherwise be accumulated by workers who change jobs frequently. The Congress believed that making a direct rollover the default option for involuntary distributions will increase the preservation of retirement savings.

Explanation of Provision¹⁴⁵

EGTRRA makes a direct rollover the default option for involuntary distributions that exceed \$1,000 and that are eligible rollover distributions from qualified retirement plans. The distribution must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

The written explanation provided by the plan administrator is required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

EGTRRA amends the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of: (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

EGTRRA directs the Secretary of Labor to issue safe harbors under which the designation of an institution and investment of funds in accordance with the provision are deemed to satisfy the requirements of section 404(a) of ERISA. In addition, the Secretary of the Treasury and the Secretary of Labor are authorized and directed to give consideration to providing special relief with respect to the use of low-cost individual retirement plans for purposes of the provision and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes.

Effective Date

The provision applies to distributions that occur after the Secretary of Labor has adopted final regulations implementing the provision. The provision directs the Secretary of Labor to adopt final regulations implementing the provision not later than three years after the date of enactment.

¹⁴⁴ Section 641 of EGTRRA expands the kinds of plans to which benefits may be rolled over.

¹⁴⁵ A technical correction was enacted in section 411(t) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify this provision.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$7 million in 2004, \$29 million in 2005, \$30 million in 2006, \$32 million in 2007, \$33 million annually in 2008 and 2009, \$34 million in 2010, \$26 million in 2011, and \$10 million in 2012.

(g) Clarification of treatment of contributions to a multiemployer plan (sec. 658 of the Act)

Present and Prior Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, contributions are deductible for the taxable year of the employer in which the contributions are made. Under a special rule, an employer may be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is on account of the preceding taxable year and is made not later than the time prescribed by law for filing the employer's income tax return for that taxable year (including extensions).¹⁴⁶

A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or taking of a deduction.¹⁴⁷ A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

Reasons for Change

The Congress was aware that the interaction of the rules regarding employer contributions to qualified retirement plans and the rules regarding what constitutes a method of accounting has resulted in some uncertainty for taxpayers. Specifically, there was some uncertainty regarding whether the determination of whether a contribution to a multiemployer pension plan is on account of a prior year under section 404(a)(6) is considered a method of accounting. The uncertainty regarding this issue has resulted in disputes between taxpayers and the IRS that the Congress believed could be avoided by eliminating the uncertainty.

Explanation of Provision

EGTRRA clarifies that a determination of whether contributions to multiemployer pension plans are on account of a prior year under section 404(a)(6) is not a method of accounting. Thus, any taxpayer that begins to deduct contributions to multiemployer

¹⁴⁶ Section 404(a)(6).

¹⁴⁷ Treas. Reg. sec. 1.446-1(e)(2)(ii)(a).

plans as provided in section 404(a)(6) has not changed its method of accounting and is not subject to an adjustment under section 481. The provision is intended to respect, not disturb, the effect of the statute of limitations. The provision is not intended to permit, as of the end of the taxable year, aggregate deductions for contributions to a qualified plan in excess of the amounts actually contributed or deemed contributed to the plan by the taxpayer. The Secretary of the Treasury is authorized to promulgate regulations to clarify that, in the aggregate, no taxpayer will be permitted deductions in excess of amounts actually contributed to multiemployer plans, taking into account the provisions of section 404(a)(6).

No inference is intended regarding whether the determination of whether a contribution to a multiemployer pension plan on account of a prior year under section 404(a)(6) is a method of accounting prior to the effective date of the provision.

Effective Date

The provision is effective after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$11 million in 2003, \$19 million in 2004, \$32 million in 2005, \$38 million in 2006, \$35 million in 2007, \$30 million in 2008, \$26 million in 2009, \$19 million in 2010, \$14 million in 2011, and \$3 million in 2012.

(h) Notice of significant reduction in plan benefit accruals (sec. 659 of the Act and new sec. 4980F of the Code)

Present and Prior Law

Under present and prior law, section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual unless certain notice requirements are met. Under prior law, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator must provide a written notice ("section 204(h) notice"), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order ("QDRO"), and each employee organization representing participants in the plan. The applicable Treasury regulations¹⁴⁸ provide, however, that a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addi-

¹⁴⁸Treas. Reg. sec. 1.411(d)-6.

tion, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator: (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was required to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

Under prior law, the Internal Revenue Code does not require any notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual.

Reasons for Change

The Congress was aware of recent significant publicity concerning conversions of traditional defined benefit pension plans to “cash balance” plans, with particular focus on the impact such conversions have on affected workers. Several legislative proposals were introduced to address some of the issues relating to such conversions.

The Congress believed that employees are entitled to meaningful disclosure concerning plan amendments that may result in reductions of future benefit accruals. The Congress determined that prior law did not require employers to provide such disclosure, particularly in cases where traditional defined benefit plans are converted to cash balance plans. The Congress also believed that any disclosure requirements applicable to plan amendments should strike a balance between providing meaningful disclosure and avoiding the imposition of unnecessary administrative burdens on employers, and that this balance may best be struck through the regulatory process with an opportunity for input from affected parties.

Explanation of Provision¹⁴⁹

EGTRRA adds to the Internal Revenue Code a requirement that the plan administrator of a qualified defined benefit plan or a money purchase pension plan furnish a written notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of a significant early retirement benefit or retirement-type

¹⁴⁹ A technical correction was enacted in section 411(u) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify this provision.

subsidy. The plan administrator is required to provide in this notice, in a manner calculated to be understood by the average plan participant, sufficient information (as defined in Treasury regulations) to allow participants to understand the effect of the amendment.

The notice requirement does not apply to governmental plans or church plans with respect to which an election to have the qualified plan participation, vesting, and funding rules apply has not been made (section 410(d)). EGTRRA authorizes the Secretary of the Treasury to provide a simplified notice requirement or an exemption from the notice requirement for plans with less than 100 participants and to allow any notice required under the provision to be provided by using new technologies. EGTRRA also authorizes the Secretary to provide a simplified notice requirement or an exemption from the notice requirement if participants are given the option to choose between benefits under the new plan formula and the old plan formula. In such cases, the provision will have no effect on the fiduciary rules applicable to pension plans that may require appropriate disclosure to participants, even if no disclosure is required under the provision.

The plan administrator is required to provide this notice to each affected participant, each affected alternate payee, and each employee organization representing affected participants. For purposes of the provision, an affected participant or alternate payee is a participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment.

Except to the extent provided by Treasury regulations, the plan administrator is required to provide the notice within a reasonable time before the effective date of the plan amendment. EGTRRA permits a plan administrator to provide any notice required under the provision to a person designated in writing by the individual to whom it would otherwise be provided.

EGTRRA imposes on a plan administrator that fails to comply with the notice requirement an excise tax equal to \$100 per day per omitted participant and alternate payee. No excise tax is imposed during any period during which any person subject to liability for the tax did not know that the failure existed and exercised reasonable diligence to meet the notice requirement. In addition, no excise tax is imposed on any failure if any person subject to liability for the tax exercised reasonable diligence to meet the notice requirement and such person provides the required notice during the 30-day period beginning on the first date such person knew, or exercising reasonable diligence would have known, that the failure existed. Also, if the person subject to liability for the excise tax exercised reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year of the employer will not exceed \$500,000. Furthermore, in the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved.

EGTRRA also modifies the present-law notice requirement contained in section 204(h) of Title I of ERISA to require notice similar

to the notice required under the Internal Revenue Code. In the case of an egregious failure by the plan administrator to comply with the notice requirement, the provisions of an applicable pension plan are to be applied as if the plan amendment entitled all affected individuals to the greater of: (1) the benefits to which they would have been entitled without regard to the amendment and (2) the benefits under the plan with regard to the amendment. In addition, the provision expands the current ERISA notice requirement regarding significant reductions in normal retirement benefit accrual rates to early retirement benefits and retirement-type subsidies.

It is intended under the provision that the Secretary issue the necessary regulations with respect to disclosure within 90 days of enactment. It is also intended that such guidance may be relatively detailed because of the need to provide for alternative disclosures rather than a single disclosure methodology that may not fit all situations, and the need to consider the complex actuarial calculations and assumptions involved in providing necessary disclosures.

Effective Date

The provision is effective for plan amendments taking effect on or after the date of enactment. The period for providing any notice required under the provision will not end before the last day of the three-month period following the date of enactment. Prior to the issuance of Treasury regulations, a plan is treated as meeting the requirements of the provision if the plan makes a good faith effort to comply with such requirements. The notice requirement under the provision does not apply to any plan amendment taking effect on or after the date of enactment if, before April 25, 2001, notice was provided to participants and beneficiaries adversely affected by the plan amendment (or their representatives) that was reasonably expected to notify them of the nature and effective date of the plan amendment.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

5. Reducing regulatory burdens

(a) Modification of timing of plan valuations (sec. 661 of the Act and sec. 412 of the Code)

Present and Prior Law

Under present and prior law, plan valuations are generally required annually for plans subject to the minimum funding rules. Under proposed Treasury regulations, except as provided by the Commissioner, the valuation must be as of a date within the plan year to which the valuation refers or within the month prior to the beginning of that year.¹⁵⁰

¹⁵⁰ Prop. Treas. Reg. sec. 1.412(c)(9)-1(b)(1).

Reasons for Change

While plan valuations are necessary to ensure adequate funding of defined benefit pension plans, they also create administrative burdens for employers. The Congress believed that permitting limited elections to use as the valuation date for a plan year any date within the immediately preceding plan year in the case of well-funded plans strikes an appropriate balance between funding concerns and employer concerns about plan administrative burdens.

Explanation of Provision

EGTRRA incorporates into the statute the proposed regulation regarding the date of valuations. EGTRRA also provides, as an exception to this general rule, that the valuation date with respect to a plan year may be any date within the immediately preceding plan year if, as of such date, plan assets are not less than 100 percent of the plan's current liability. Information determined as of such date is required to be adjusted actuarially, in accordance with Treasury regulations, to reflect significant differences in plan participants. A change in funding method to take advantage of the exception to the general rule may not be made unless, as of such date, plan assets are not less than 125 percent of the plan's current liability. The Secretary is directed to automatically approve changes in funding method to use a prior year valuation date if the change is within the first three years that the plan is eligible to make the change.¹⁵¹

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(b) ESOP dividends may be reinvested without loss of dividend deduction (sec. 662 of the Act and sec. 404 of the Code)

Present and Prior Law

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are: (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that

¹⁵¹ A technical correction was enacted in section 411(v) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document to clarify this provision.

were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

The Secretary may disallow the deduction for any ESOP dividend if he determines that the dividend constitutes, in substance, an evasion of taxation (section 404(k)(5)).

Reasons for Change

The Congress believed it appropriate to provide incentives for the accumulation of retirement benefits and expansion of employee ownership. The Congress determined that the prior-law rules concerning the deduction of dividends on employer stock held by an ESOP discouraged employers from permitting such dividends to be reinvested in employer stock and accumulated for retirement purposes.

Explanation of Provision

In addition to the deductions permitted under prior law for dividends paid with respect to employer securities that are held by an ESOP, an employer is entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are: (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities.¹⁵²

EGTRRA permits the Secretary to disallow the deduction for any ESOP dividend if the Secretary determines that the dividend constitutes, in substance, the avoidance or evasion of taxation. This includes authority to disallow a deduction of unreasonable dividends. For purposes of the dividends reinvested at the election of participants or beneficiaries, a dividend paid on common stock that is primarily and regularly traded on an established securities market would be reasonable. In addition, for this purpose in the case of employers with no common stock (determined on a controlled group basis) that is primarily and regularly traded on an established securities market, the reasonableness of a dividend is determined by comparing the dividend rate on stock held by the ESOP with the dividend rate for common stock of comparable corporations whose stock is primarily and regularly traded on an established securities market. Whether a corporation is comparable is determined by comparing relevant corporate characteristics such as industry, corporate size, earnings, debt-equity structure and dividend history.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

¹⁵²A technical correction enacted in section 411(w) of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, to clarify that, with respect to dividends that are reinvested at the election of participants, the dividends are deductible for the taxable year in which the later of the reinvestment or the election occurs and the dividends must be nonforfeitable.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$20 million in 2002, \$49 million in 2003, \$59 million in 2004, \$63 million in 2005, \$66 million in 2006, \$69 million in 2007, \$71 million in 2008, \$74 million in 2009, \$77 million in 2010, \$39 million in 2011, and less than \$5 million in 2012.

(c) Repeal transition rule relating to certain highly compensated employees (sec. 663 of the Act and sec. 1114(c)(4) of the Tax Reform Act of 1986)

Present and Prior Law

Under present and prior law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee¹⁵³ who (1) was a five-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of \$85,000 (for 2001) or (b) at the election of the employer, had compensation in excess of \$85,000 for the preceding year and was in the top 20 percent of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements (“section 401(k) plans”) and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

Reasons for Change

The Congress believed it appropriate to repeal the special definition of highly compensated employee in light of the substantial modification of the general definition of highly compensated employee in the Small Business Job Protection Act of 1996.

Explanation of Provision

The provision repeals the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the generally applicable definition applies in all cases.

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$2 million in 2002, \$3 million annually in 2003 through 2006, \$4 million annually in 2007 through 2010, \$2 million in 2011, and less than \$500,000 in 2012.

¹⁵³An employee includes a self-employed individual.

(d) Employees of tax-exempt entities (sec. 664 of the Act)***Present and Prior Law***

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement (“section 401(k) plan”). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, in applying the non-discrimination rules to a section 401(k) plan (or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan), the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees may be disregarded only if more than 95 percent of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.¹⁵⁴

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a “section 403(b) annuity”) that allows employees to make salary reduction contributions.

Reasons for Change

The Congress believed it appropriate to modify the special rule regarding the treatment of certain employees of a tax-exempt organization as excludable for section 401(k) plan nondiscrimination testing purposes in light of the provision of the Small Business Job Protection Act of 1996 that permits such organizations to maintain section 401(k) plans.

Explanation of Provision

The Treasury Department is directed to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if: (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) at least 95 percent of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations are to be effective for years beginning after December 31, 1996.

Effective Date

The provision is effective on the date of enactment.

¹⁵⁴Treas. Reg. sec. 1.410(b)-6(g).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(e) Treatment of employer-provided retirement advice (sec. 665 of the Act and sec. 132 of the Code)

Present and Prior Law

Under present and prior law, certain employer-provided fringe benefits are excludable from gross income (section 132) and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable.

In addition, if certain requirements are satisfied, up to \$5,250 annually of employer-provided educational assistance is excludable from gross income (section 127) and wages. Under prior law, this exclusion did not apply with respect to graduate-level courses and expired with respect to courses beginning after December 31, 2001.¹⁵⁵ Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under prior law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

Reasons for Change

In order to plan adequately for retirement, individuals must anticipate retirement income needs and understand how their retirement income goals can be achieved. Employer-sponsored plans are a key part of retirement income planning. The Congress believed that employers sponsoring retirement plans should be encouraged to provide retirement planning services for their employees in order to assist them in preparing for retirement.

Explanation of Provision

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludable from income and wages. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and

¹⁵⁵Section 411 of EGTRRA, also described in Part Two of this document, provides for the: (1) permanent extension of the exclusion for employer-provided educational assistance; and (2) expansion of the exclusion to graduate education. These changes are effective with respect to courses beginning after December 31, 2001.

information regarding the employer's qualified plan. "Qualified retirement planning services" are retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

It is intended that the provision will clarify the treatment of retirement advice provided in a nondiscriminatory manner. It is intended that the Secretary, in determining the application of the exclusion to highly compensated employees, may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

Effective Date

The provision is effective with respect to years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

(f) Repeal of the multiple use test (sec. 666 of the Act and sec. 401(m) of the Code)

Present and Prior Law

Under present and prior law, elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan") are subject to a special annual nondiscrimination test ("ADP test"). The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

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

Employer matching contributions and after-tax employee contributions under a defined contribution plan also are subject to a

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

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

Under prior law, for any year in which: (1) at least one highly compensated employee is eligible to participate in an employer’s plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125 percent of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly compensated employee group exceeds 125 percent of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test (“multiple use test”) applies to the elective deferrals, employer matching contributions, and after-tax employee contributions. The plan or plans generally satisfy the multiple use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of: (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

Reasons for Change

The Congress believed that the ADP test and the ACP test are adequate to prevent discrimination in favor of highly compensated employees under 401(k) plans and determined that the multiple use test unnecessarily complicates 401(k) plan administration.

Explanation of Provision

EGTRRA repeals the multiple use test.

Effective Date

The provision is effective for years beginning after December 31, 2001.

Revenue Effect

The estimated revenue effect of this provision is considered in the estimated revenue effect of other provisions of Title VI of EGTRRA.

C. Tax Treatment of Electing Alaska Native Settlement Trusts (sec. 671 of the Act, secs. 1(e), 301, 641, 651, 661, and 6034A of the Code and new secs. 646 and 6039H of the Code)

Present and Prior Law

An Alaska Native Settlement Corporation (“ANC”) may establish a Settlement Trust (“Trust”) under section 39 of the Alaska Native Claims Settlement Act (“ANCSA”)¹⁵⁶ and transfer money or other property to such Trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives.

With certain exceptions, once an ANC has made a conveyance to a Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Trust.

The Internal Revenue Service (“IRS”) has indicated that contributions to a Trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent of earnings and profits as provided under section 301 of the Code.¹⁵⁷ Also, a Trust and its beneficiaries are generally taxed subject to applicable trust rules.¹⁵⁸

Reasons for Change

Congress was concerned that prior law might inhibit many ANCs from establishing Settlement Trusts, due to the IRS treatment of a contribution by an ANC to a Trust as a dividend to the extent the ANC has current or accumulated earnings and profits in the year of the contribution. So long as the ANC shareholders or beneficiaries of the Trust do not receive the money or other property that is contributed to the Trust, Congress believed it appropriate to allow the transfer to the Trust without causing dividend treatment.

Congress also believed it appropriate for a Settlement Trust to be able to accumulate its earnings at the lowest individual tax rate rather than the higher rates that generally apply to trusts, and to distribute earnings taxed at that rate to Alaska Native beneficiaries without additional taxation to the beneficiaries.

¹⁵⁶ 43 U.S.C. 1601 et. seq. A Settlement Trust is subject to certain limitations under ANCSA, including that it may not operate a business. 43 U.S.C. 1629e(b).

¹⁵⁷ See, e.g., Priv. Ltr. Rul. 9824014; Priv. Ltr. Rul. 9433021; Priv. Ltr. Rul. 9329026 and Priv. Ltr. Rul. 9326019.

¹⁵⁸ See Subchapter J of the Code (sections 641 et. seq.); Treas. Reg. sec. 1.301.7701-4.

At the same time, Congress believed it appropriate to require a Settlement Trust to elect to obtain the benefits of the new provisions, and to provide safeguards for such electing Trusts that prevent the benefits from being used by persons other than Alaska Natives, or from being used to circumvent basic tax law provisions in an unintended manner.

Explanation of Provision

EGTRRA allows an election under which special rules will apply in determining the income tax treatment of an electing Trust and of its beneficiaries. An electing Trust will pay tax on its income at the lowest rate specified for ordinary income of an individual (or corresponding lower capital gains rate). EGTRRA also specifies the treatment of distributions by an electing Trust to beneficiaries, the reporting requirements associated with such an election, and the consequences of disqualification for these benefits due to the allowance of certain impermissible dispositions of Trust interests or ANC stock.

Under EGTRRA, a trust that is a Settlement Trust established by an Alaska Native Corporation under section 39 of ANCSA may make an election for its first taxable year ending after the date of enactment of the provision to be subject to the rules of the provision rather than otherwise applicable income tax rules. If the election is in effect, no amount will be included in the gross income of a beneficiary of such Trust by reason of a contribution to the Trust.¹⁵⁹ In addition, ordinary income of the electing Trust, whether accumulated or distributed, will be taxed only to the Trust (and not to beneficiaries) at the lowest individual tax rate for ordinary income. Capital gains of the electing Trust will similarly be taxed to the Trust at the capital gains rate applicable to individuals subject to such lowest rate. These rates will apply, rather than the higher rates generally applicable to trusts or to higher tax bracket beneficiaries. The election is made on a one-time basis only. The benefits of the election will terminate, however, and other special rules will apply, if the electing Trust or the sponsoring ANC fail to satisfy the restrictions on transferability of Trust beneficial interests or of ANC stock. A Trust that makes the election remains subject to the generally applicable requirements for classification and taxation as a trust, in order to obtain the benefits of the provision.

The treatment to beneficiaries of amounts distributed by an electing Trust depends upon the amount of the distribution. Solely for purposes of determining what amount has been distributed and thus which treatment applies under these rules, the amount of any distribution of property is the fair market value of the property at the time of the distribution.¹⁶⁰

¹⁵⁹ If the ANC transfers appreciated property to the Trust, section 311(b) of the Code will apply to the ANC, as under present law, so that the ANC will recognize gain as if it had sold the property for fair market value. The Trust takes the property with a fair market value basis, pursuant to section 301(d) of the Code.

¹⁶⁰ Section 661 of the Code, which provides a deduction to the trust for certain distributions, does not apply to an electing Trust under the provision unless the election is terminated by disqualification. Similarly, the inclusion provisions of section 662 of the Code, relating to amounts to be included in income of beneficiaries, also do not apply to a qualified electing Trust.

Amounts distributed by an electing Trust during any taxable year are excludable from the gross income of the recipient beneficiary to the extent of: (1) the taxable income of the Trust for the taxable year and all prior taxable years for which an election was in effect (decreased by any income tax paid by the Trust with respect to the income) plus (2) any amounts excluded from gross income of the Trust under section 103 for those periods.¹⁶¹

If distributions to beneficiaries exceed the excludable amounts described above, then such excess distributions are reported and taxed to beneficiaries as if distributed by the ANC in the year of the distribution by the electing Trust to the extent the ANC then has current or accumulated earnings and profits, and are treated as dividends to beneficiaries.¹⁶² Additional distributions in excess of the current or accumulated earnings and profits of the ANC are treated by the beneficiaries as distributions by the Trust in excess of the distributable net income of the Trust for such year.¹⁶³

The fiduciary of an electing Trust must report to the IRS, with the Trust tax return, the amount of distributions to each beneficiary, and the tax treatment to the beneficiary of such distributions under the provision (either as exempt from tax to the beneficiary, or as a distribution deemed made by the ANC). The electing Trust must also furnish such information to the ANC. In the case of distributions that are treated as if made by the ANC, the ANC must then report such amounts to the beneficiaries and must indicate whether they are dividends or not, in accordance with the earnings and profits of the ANC. The reporting thus required by an electing Trust will be in lieu of, and will satisfy, the reporting requirements of section 6034A (and such other reporting requirements as the Secretary of the Treasury may deem appropriate).

The earnings and profits of an ANC will not be reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the ANC earnings and profits will be reduced as and when distributions are thereafter made by the electing Trust that are taxed to beneficiaries under the provision as dividends from the ANC to the Trust beneficiaries.

If in any taxable year the beneficial interests in the electing Trust may be disposed of to a person in a manner that would not be permitted under ANCSA if the interests were Settlement Common Stock (generally, to a person other than an Alaska Native),¹⁶⁴

¹⁶¹In the case of any such excludable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary will generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary would be the fair market value of the property. *See* Code sections 643(e) and 643(e)(3).

¹⁶²The treatment of such amounts distributed by an electing Trust as a dividend applies even if all or any part of the contributions by an ANC to a Trust would not have been dividends at the time of the contribution under present law; for example, because the ANC had no current or accumulated earnings and profits, or because the contribution was made from Alaska Native Fund amounts that may not have been taxable. *See* 43 U.S.C. 1605.

¹⁶³Such distributions would not be taxable to the beneficiaries. In the case of any such nontaxable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary will generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary will be the fair market value of the property. *See* Code sections 643(e) and 643(e)(3).

¹⁶⁴Under ANSCA, Settlement Common Stock is subject to restrictions on transferability. If changes are made to permit additional transferability of such stock, then the Settlement Com-

then the special provisions applicable to electing Trusts, including the favorable ordinary income tax rate and corresponding lower capital gains tax rate, cease to apply as of the beginning of such taxable year. The distributable net income of the Trust is increased up to the amount of current and accumulated earnings and profits of the ANC as of the end of that year, but such increase shall not exceed the fair market value of the assets of the Trust as of the date the beneficial interests of the Trust became disposable.¹⁶⁵ Thereafter, the Trust and its beneficiaries are generally subject to the rules of subchapter J and to the generally applicable trust income tax rates. Thus, the increase in distributable net income will result in the Trust being taxed at regular trust rates to the extent the recomputed distributable net income is not distributed to beneficiaries; and beneficiaries will be taxed to the extent there are distributions. Normal reporting rules applicable to trusts and their beneficiaries will apply. The basis of any property distributed to beneficiaries will also be determined under normal trust rules. The same rules apply if any stock of the ANC may be disposed of to a person in a manner that would not be permitted under ANCSA if the stock were Settlement Common Stock and the ANC makes a transfer to the Trust.¹⁶⁶

EGTRRA contains a special loss disallowance rule that reduces any loss that would otherwise be recognized by a shareholder upon the disposition of a share of stock of a sponsoring ANC by a “per share loss adjustment factor.” This factor reflects the aggregate of all contributions to all electing Trusts sponsored by such ANC made on or after the first day such Trust is treated as an electing Trust, expressed on a per share basis and determined as of the day of each such contribution.

The special loss disallowance rule is intended to prevent the allowance of noneconomic losses if the ANC stock owned by beneficiaries ever becomes transferable in any type of transaction that could cause the recognition of taxable gain or loss, (including a redemption by the ANC) where the basis of the stock in the hands of the beneficiary (or in the hands of any transferee of a beneficiary) fails to reflect the allocable reduction in corporate value attributable to amounts transferred by the ANC into the Trust.

Effective Date

The provision is effective for taxable years of Settlement Trusts, their beneficiaries, and sponsoring Alaska Native Corporations

mon Stock is cancelled and Replacement Common Stock is issued. See 43 U.S.C. 1602(p), 1606(h) and 1629c.

¹⁶⁵To the extent the earnings and profits of the ANC increase distributable net income of the Trust under this provision, the ANC will have a corresponding adjustment reducing its earnings and profits.

¹⁶⁶The restrictions on transfer of stock or beneficial interests under the provision are those that would apply to Settlement Common Stock under section 7(h) of ANSCA (43 U.S.C. 1606(h)), whether or not the interest or stock in question is in fact Settlement Common Stock. To the extent section 7(h) of ANSCA permits certain transfers of Settlement Common stock on death or in other special circumstances, those are also permitted under the provision. Also, the mere transferability of ANC stock in manner that would not be permitted for Settlement Common Stock (but without such transferability of any Trust interests) will not destroy the beneficial treatment of an existing electing Trust unless and until the ANC thereafter makes a transfer to the Trust. The surrender of an interest in an ANC or an electing Trust in order to accomplish the whole or partial redemption of the interest of a shareholder or beneficiary in such ANC or Trust, or to accomplish the whole or partial liquidation of such ANC or Trust, is deemed to be a transfer permitted by section 7(h) of ANSCA for purposes of the provision.

ending after the date of enactment, and to contributions made to electing Settlement Trusts during such year and thereafter.

The general sunset date is effective for taxable years beginning after December 31, 2010. For such taxable years, the tax consequences of any election previously made under the provision, and any right to make a future election, shall be terminated. Thus, for taxable years beginning after December 31, 2010, any electing Trust then in existence, its beneficiaries, and the sponsoring ANC shall be taxed under the provisions of law in effect immediately prior to the enactment of this provision.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by \$4 million annually in 2002 and 2003, \$3 million annually in 2004 through 2008, \$4 million annually in 2009 and 2010, and \$1 million in 2011.

VII. ALTERNATIVE MINIMUM TAX

A. Individual Alternative Minimum Tax Relief (sec. 701 of the Act and sec. 55 of the Code)

Present and Prior Law

Prior and present law impose an alternative minimum tax (“AMT”) on individuals to the extent that the tentative minimum tax exceeds the regular tax. An individual’s tentative minimum tax generally is an amount equal to the sum of: (1) 26 percent of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income (“AMTI”) in excess of an exemption amount and (2) 28 percent of the remaining AMTI. AMTI is the individual’s taxable income adjusted to take account of specified preferences and adjustments.

Under prior law, the AMT exemption amounts were: (1) \$45,000 in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 in the case of other unmarried individuals; and (3) \$22,500 in the case of married individuals filing a separate return, estates and trusts. Under present and prior law, the exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual’s AMTI exceeds: (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. The exemption amounts, the threshold phase-out amounts, and rate brackets are not indexed for inflation.

Reasons for Change

The Congress was concerned about the projected increase in the number of individuals who will be affected by the individual alternative minimum tax in future years. The provision will reduce the number of individuals who would otherwise be affected by the minimum tax.

Explanation of Provision

EGTRRA increases the AMT exemption amount for married couples filing a joint return and surviving spouses by \$4,000. The AMT exemption amounts for other individuals (i.e., unmarried individuals and married individuals filing separate returns) are increased by \$2,000.

Effective Date

The provision applies to taxable years beginning after December 31, 2000, and before January 1, 2005.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$178 million in 2001, \$2,311 million in 2002, \$3,161 million in 2003, \$4,605 million in 2004, and \$3,646 in 2005.

VIII. OTHER PROVISIONS

A. Modification to Corporate Estimated Tax Requirements (sec. 801 of the Act)

Present and Prior Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability (section 6655). For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Reasons for Change

The Congress believed that it was appropriate to modify these corporate estimated tax requirements.

Explanation of Provision

With respect to corporate estimated tax payments due on September 17, 2001,¹⁶⁷ 100 percent is required to be paid by October 1, 2001. With respect to corporate estimated tax payments due on September 15, 2004, 80 percent is required to be paid by September 15, 2004, and 20 percent is required to be paid by October 1, 2004.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$32,921 million in 2001, increase Federal fiscal year budget receipts by \$32,921 million in 2002, have no effect on Federal fiscal year budget receipts in 2003, reduce Federal fiscal year budget receipts by \$6,606 million in 2004, and increase Federal fiscal year budget receipts by \$6,606 million in 2005.

B. Authority to Postpone Certain Tax-Related Deadlines by Reason of Presidentially Declared Disaster (sec. 802 of the Act and sec. 7508A of the Code)

Present and Prior Law

The Secretary of the Treasury may specify that certain deadlines are postponed for a period of time in the case of a taxpayer deter-

¹⁶⁷ September 15, 2001 was a Saturday. Under present and prior law, payments required to be made on a Saturday must be made no later than the next banking day.

mined to be affected by a Presidentially declared disaster.¹⁶⁸ The deadlines that may be postponed are the same as the deadlines postponed by reason of service in a combat zone. If the Secretary extends the period of time for filing income tax returns and for paying income tax, the Secretary must abate related interest for that same period of time.¹⁶⁹ Under prior law, the Secretary of the Treasury had the authority to specify that certain deadlines are postponed for a period of up to 90 days.

Reasons for Change

The Congress believed that increasing the maximum time period for which the Secretary may postpone certain deadlines in the case of a taxpayer determined to be affected by a Presidentially declared disaster will help taxpayers in dealing with disasters.

Explanation of Provision

EGTRRA expands the period of time with respect to which the Secretary may postpone certain deadlines from 90 days to 120 days.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than \$500,000 in 2002, and by less than \$1 million annually in 2003 through 2012.

C. Income Tax Treatment of Certain Restitution Payments to Holocaust Victims (sec. 803 of the Act)

Present and Prior Law

Under the Code, gross income means “income from whatever source derived” except for certain items specifically exempt or excluded by statute (section 61). There is no explicit statutory exception from gross income provided for amounts received due to status as a Holocaust victim or heir thereof.

Explanation of Provision

EGTRRA provides that excludable restitution payments made to an eligible individual (or the individual’s heirs or estate) are: (1) excluded from gross income; and (2) not taken into account for any provision of the Code which takes into account excludable gross income in computing adjusted gross income (e.g., taxation of Social Security benefits).

The basis of any property received by an eligible individual (or the individual’s heirs or estate) that is excluded under this provision is the fair market value of such property at the time of receipt by the eligible individual (or the individual’s heirs or estate).

¹⁶⁸ Section 7508A.
¹⁶⁹ Section 6404(h).

Eligible restitution payments are any payment or distribution made to an eligible individual (or the individual's heirs or estate) which: (1) is payable by reason of the individual's status as an eligible individual (including any amount payable by any foreign country, the United States, or any foreign or domestic entity or fund established by any such country or entity, any amount payable as a result of a final resolution of legal action, and any amount payable under a law providing for payments or restitution of property); (2) constitutes the direct or indirect return of, or compensation or reparation for, assets stolen or hidden, or otherwise lost to, the individual before, during, or immediately after World War II by reason of the individual's status as an eligible individual (including any proceeds of insurance under policies issued on eligible individuals by European insurance companies immediately before and during World War II); or (3) interest payable as part of any payment or distribution described in (1) or (2), above. An eligible individual is a person who was persecuted for racial or religious reasons or on the basis of physical or mental disability or sexual orientation by Nazi Germany, or any other Axis regime, or any other Nazi-controlled or Nazi-allied country.

EGTRRA also provides that interest earned by enumerated escrow or settlement funds are excluded from tax.

Effective Date

The provision is effective for any amounts received on or after January 1, 2000. No inference is intended with respect to the income tax treatment of any amount received before January 1, 2000.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$3 million annually in 2003–2011.

**IX. COMPLIANCE WITH CONGRESSIONAL BUDGET ACT
(Sec. 901 of the Act)**

Present and Prior Law

There are no general sunset provisions provided in other tax legislation. One is provided in EGTRRA to ensure compliance with the reconciliation rules.

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

- (1) It does not produce a change in outlays or revenues;
- (2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;
- (3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;
- (4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;
- (5) It would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; and
- (6) It recommends changes in Social Security.

Explanation of Provision

Sunset of provisions

To ensure compliance with the Budget Act (see definition number 5 of the Byrd rule, above), EGTRRA provides that the provisions of, and amendments made by, the Act that are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011, except that all provisions of, and amendments made by, the bill generally do not apply for taxable, plan or limitation years beginning after December 31, 2010. With respect to the estate, gift, and generation-skipping provisions of the bill, the provisions do not apply to estates of decedents dying, gifts made, or generation skip-

ping transfers, after December 31, 2010. The Code and the Employee Retirement Income Security Act of 1974 are applied to such years, estates, gifts and transfers after December 31, 2010, as if the provisions of and amendments made by the bill had never been enacted.

Effective Date

This provision is effective on the date of enactment (June 7, 2001).

Revenue Effect

The revenue effects of this provision are incorporated in the revenue effects of each provision of EGTRRA, as described above.

PART THREE: AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO RENAME THE EDUCATION INDIVIDUAL RETIREMENT ACCOUNTS AS THE COVERDELL EDUCATION SAVINGS ACCOUNTS (PUBLIC LAW 107-22)¹⁷⁰

A. Education Individual Retirement Accounts (sec. 1 of the Act and sec. 530 of the Code)

Present and Prior Law

Section 530 of the Code provides tax-exempt status to education individual retirement accounts (“education IRAs”), meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash.¹⁷¹ Annual contributions to education IRAs may not exceed \$2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution from an education IRA, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary’s gross income.

The earnings portion of a distribution from an education IRA that is includible in income is generally subject to an additional 10-percent tax. The 10-percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship).

¹⁷⁰S. 1190. The bill was introduced in, and passed by, the Senate on July 18, 2001. S. 1190 was discharged by the House Committee on Ways and Means and passed by the House on July 23, 2001. The President signed the bill on July 26, 2001. The bill was not reported by any Committee of the House of Representatives or the Senate. Therefore, the bill does not have any formal legislative history. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

¹⁷¹Special estate and gift tax rules apply to qualified tuition programs and education IRAs.

Explanation of Provision

The provision renames education individual retirement accounts as Coverdell education savings accounts.

Effective Date

The provision is effective on the date of enactment (July 26, 2001).

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

PART FOUR: THE REVENUE PROVISIONS OF THE RAILROAD RETIREMENT AND SURVIVORS' IMPROVEMENT ACT OF 2001 (PUBLIC LAW 107-90)¹⁷²

A. Amendments to the Internal Revenue Code of 1986 (the "Code") (secs. 201-204 of the Act and secs. 501, 3201, 3211, 3221, and 3241 of the Code)

Present and Prior Law

In general

Present and prior law also imposes a tier 1 tax on railroad employers, employees, and employee representatives. This tax is essentially equivalent to Social Security taxes, and is used primarily to fund tier 1 benefits, which are essentially equivalent to Social Security benefits. Tier 2 railroad retirement benefits are funded primarily through a tier 2 payroll tax. Prior law also imposed a supplemental annuity tax, which was used to finance supplemental annuity benefits, as well as some tier 2 benefits.

Tier 2 payroll taxes

Present and prior law imposes a tier 2 payroll tax on railroad employers, employees, and employee representatives. The tax on employers was equal to 16.1 percent of covered compensation for 2001. The employee-level tax was equal to 4.9 percent of covered compensation for 2001.¹⁷³ The tier 2 tax on railroad employee representatives was equal to 14.75 percent of covered compensation for 2001.

The maximum amount of compensation taken into account for tier 2 payroll tax purposes is \$59,700 (for 2001).

Supplemental annuity tax

A cents-per-hour tax was imposed on railroad employers and employee representatives to fund supplemental annuity benefits. The rate of tax was determined quarterly by the Railroad Retirement Board based on the level necessary to fund current benefits, plus administrative costs. The rate of tax was 26.5 cents per hour. Special rules applied in the case of an employer with respect to employees covered by a supplemental pension plan established pursuant to collective bargaining.

¹⁷²H.R. 10. H.R. 1140, the "Railroad Retirement and Survivors' Improvement Act of 2001," was referred to the House Committee on Transportation and Infrastructure, which reported the bill by a voice vote (H.R. Rep. 107-82) and House Committee on Ways and Means which discharged the bill. The House passed the bill on July 31, 2001 on a motion to suspend the rules and pass the bill. The bill was referred to the Senate Committee on Finance. The text of H.R. 1140 was substituted into H.R. 10 on the Senate floor and passed on December 5, 2001. The bill as amended by the Senate passed the House on December 11, 2001, on a motion to suspend the rules and pass the bill. The bill was signed by the President on December 21, 2001.

¹⁷³Like tier 1 and Social Security taxes, the employee-level tier 2 tax is deducted from the employee's compensation and remitted by the employer.

Reasons for Change¹⁷⁴

The Act reduced the tier 2 payroll tax rate paid by employers and employee representatives and provides a tax adjustment mechanism for years after 2003. According to the Railroad Retirement Board, the assets of the Railroad Retirement Account at the end of 2001 would be sufficient to pay more than 5 years of benefits. As a result, the tier 2 tax rate could be lowered over the next two years (2002–2003) without impacting the ability to pay benefits. After 2003, the tax rate would be set each calendar year pursuant to a statutory formula based on the average benefit ratio. If the program becomes underfunded, the tax rate would automatically increase to bolster the system's income, placing the burden and investment risk on the industry rather than the general taxpayer. Alternatively, if the trust fund balance increases to a certain level relative to benefit payments, tax rates would decrease. The automatic tax adjustment mechanism allows the tax rate to be more responsive to the system's financing needs.

Explanation of Provision

In general

The Act makes the following changes to the Code: (1) lowers the tier 2 payroll tax rates for employers and employee representatives in 2002 and 2003 and provides a modified method of calculating the rate of all tier 2 taxes after 2003; (2) repeals the supplemental annuity tax; and (3) provides tax-exempt status for the railroad retirement investment trust (the "Trust") created by the Act. The Trust for tier 2 benefits has the authority to invest the assets of the Trust on behalf of the Railroad Retirement Board and to transfer the funds to a qualified financial institution appointed as a disbursing agent for the payment of railroad retirement benefits.

Payroll taxes

The Act lowers the tier 2 tax rate on employers to 15.6 percent of covered compensation in 2002 and 14.2 percent in calendar year 2003. The Act lowers the tier 2 tax rate for employee representatives to 14.75 percent of covered compensation in 2002 and 14.2 percent in calendar year 2003. The Act does not change the tier 2 tax on employees for 2002 and 2003.

Beginning in calendar year 2004, the Act provides for automatic modifications in the tier 2 tax rates for employers, employee representatives, and employees based on the ratio of certain asset balances to the sum of benefits and administrative expenses (the "average account benefits ratio"). The average account benefits ratio is the sum of the account benefits ratio for the previous 10 fiscal years divided by 10. The account benefits ratio is determined by dividing the sum of the fair market value of the assets in the railroad retirement account and the Trust at the close of the fiscal year by the sum of total benefit payments and administrative expenses of the Trust for such fiscal year. Because the average ac-

¹⁷⁴See H.R. 4844, the "Railroad Retirement and Survivor's Improvement Act of 2000," which was reported by the Senate Committee on Finance on October 3, 2000 (S. Rep. No. 106-475) during the 106th Congress. The revenue provisions of that bill are substantially similar to the revenue provisions of the Railroad Retirement and Survivor's Improvement Act of 2001.

count benefits ratio is expected to be between 4.0 and 6.1 in 2004, the table is designed to produce a 13.10 tax rate for employers and employee representatives and a 4.9 tax rate for employees in calendar year 2004. The Secretary of the Treasury is to use the following table to make adjustments to the tier 2 tax rates.

Average account benefits ratio		Applicable percentage for employer and employee representative tier 2 taxes (percent)	Applicable percentage for employee tier 2 taxes (percent)
At least	But less than		
	2.5	22.1	4.9
2.5	3.0	18.1	4.9
3.0	3.5	15.1	4.9
3.5	4.0	14.1	4.9
4.0	6.1	13.1	4.9
6.1	6.5	12.6	4.4
6.5	7.0	12.1	3.9
7.0	7.5	11.6	3.4
7.5	8.0	11.1	2.9
8.0	8.5	10.1	1.9
8.5	9.0	9.1	0.9
9.0 .....	.....	8.2	0

Supplemental annuity tax

The Act repeals the supplemental annuity tax.¹⁷⁵ Supplemental annuity benefits are not affected by the elimination of the supplemental annuity tax.

Tax exemption for the Trust

The Act provides tax-exempt status for the newly created Trust under Code section 501(c).

Effective Date

The provisions generally are effective for calendar years beginning after December 31, 2001. The provision relating to the tax-exempt status of the Trust is effective on the date of enactment.

Revenue Effect

The provision to repeal the supplemental annuity tax is estimated to reduce Federal fiscal year budget receipts by \$59 million in 2002, \$79 million in 2003, \$81 million in 2004, \$79 million in 2005, \$77 million in 2006, \$76 million in 2007, \$75 million in 2008, \$75 million in 2009, \$74 million annually in 2010, 2011, and 2012.¹⁷⁶

The provision to adjust the tier 2 tax rate is estimated to reduce Federal fiscal year budget receipts by \$59 million in 2002, \$198

¹⁷⁵The funds in the supplemental annuity account were to be transferred to the Fund and the account was to be eliminated by the Railroad Retirement Board as soon as possible after December 31, 2001.

¹⁷⁶Estimate provided by the Congressional Budget Office.

million in 2003, \$329 million in 2004, \$362 million in 2005, \$366 million in 2006, \$374 million in 2007, \$379 million in 2008, \$383 million in 2009, \$384 million in 2010, \$386 million in 2011 and \$390 million in 2012.¹⁷⁷

¹⁷⁷ Estimate provided by the Congressional Budget Office.

**PART FIVE: THE REVENUE PROVISIONS OF AN ACT
MAKING APPROPRIATIONS FOR THE DEPARTMENTS
OF LABOR, HEALTH AND HUMAN SERVICES, AND EDU-
CATION, AND RELATED AGENCIES FOR THE FISCAL
YEAR ENDING SEPTEMBER 30, 2002, AND FOR OTHER
PURPOSES (PUBLIC LAW 107-116)**¹⁷⁸

**A. Tax on Failure to Comply with Mental Health Parity Re-
quirements (sec. 701 of the Act and sec. 9812(f) of the
Code)**

Present and Prior Law

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, and expired with respect to benefits for services furnished on or after September 30, 2001.

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to \$100 per day during the period of noncompliance and is imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or \$500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed. The excise tax is applicable with respect to plan years beginning on or after January 1, 1998, and under prior law expired with respect to benefits for services provided on or after September 30, 2001.

Explanation of Provision

The excise tax (and the mental health parity requirements) are restored retroactively to September 30, 2001, and will expire with

¹⁷⁸H.R. 3061. The House Committee on Appropriations reported the bill as an original measure on October 9, 2001 (H. R. Rep. No. 107-229). The House passed the bill with amendments on October 11, 2001. The Senate passed the bill with an amendment on November 6, 2001. A Conference report was filed on the bill on December 19, 2001 (H. R. Rep. No. 107-342). The House agreed to the Conference report on December 19, 2001. The Senate agreed to the Conference report on December 20, 2001. The President signed the bill on January 10, 2002.

respect to benefits provided for services on or after December 31, 2002.¹⁷⁹

Effective Date

The provision is effective September 30, 2001.

Revenue Effect

The provision will have a negligible effect on excise tax receipts.

¹⁷⁹Section 610 of the Job Creation and Worker Assistance Act of 2002, described in Part Eight of this document, subsequently amended the Internal Revenue Code provision so that the excise tax on failures to comply with mental health parity requirements applies to benefits for such services provided on or after January 10, 2002, and before January 1, 2004. Pub. L. No. 107-313, the Mental Health Parity Reauthorization Act of 2002, enacted December 2, 2002, amends ERISA and the Public Health Service Act to extend the mental health parity requirements through December 31, 2003.

PART SIX: AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO SIMPLIFY THE REPORTING REQUIREMENTS RELATING TO HIGHER EDUCATION TUITION AND RELATED EXPENSES (PUBLIC LAW 107-131)¹⁸⁰

A. Simplify the Reporting Requirements Relating to Higher Education Tuition and Related Expenses (sec. 1 of the Act and sec. 6050S of the Code)

Prior Law

Section 6050S of the Code imposes reporting requirements, related to higher education tax benefits, on eligible educational institutions and certain other persons. Under prior law, an eligible educational institution is subject to the reporting requirements if the institution receives payments for qualified tuition and related expenses with respect to any individual for any calendar year, or makes reimbursements or refunds (or similar amounts) of qualified tuition and related expenses to any individual. The information a person subject to the reporting requirements is required to provide includes the following: (1) the name, address, and taxpayer identification number of an individual with respect to whom payments were received; (2) the name, address, and taxpayer identification number of any individual certified by the individual described in (1) as the taxpayer who will claim the individual as a dependent for the year; and (3) the aggregate amount of payments for qualified tuition and related expenses received with respect to the individual during the calendar year, the aggregate amount of reimbursements or refunds (or similar amounts) paid to such individual during the calendar year by the person making the return, and the amount of any grant received by such individual for payment of costs of attendance and processed by the person making the return.

Explanation of Provision

The Act makes a number of changes to these reporting requirements. First, the Act replaces the rule described above regarding whether an educational institution is subject to the reporting requirements with a rule that provides that eligible educational institutions are subject to the reporting requirements if the institution enrolls any individual for any academic period. Second, the Act replaces the requirement in (1) above with a requirement that the in-

¹⁸⁰H.R. 3346. The bill was introduced November 27, 2001, and passed by the House on December 4, 2001 on a motion to suspend the rules and pass the bill. The Senate passed the bill without amendment by unanimous consent on December 20, 2001. The bill was signed by the President on January 16, 2002. The bill was not reported by any Committee of the House of Representatives or the Senate. Therefore, the bill does not have any formal legislative history. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

formation return include the name, address, and taxpayer identification number of any individual (a) who is or has been enrolled at an eligible education institution and with respect to whom certain transactions are made or (b) with respect to whom certain payments were made or received. Third, the Act eliminates the reporting requirement with respect to the information described in (2), above (relating to the taxpayer who will claim the individual as a dependent). Finally, the Act replaces the requirement described in (3) above, with a requirement that the following information be provided: (a) the aggregate amount of payments received or the aggregate amount billed for qualified tuition and related expenses during the calendar year; (b) the aggregate amount of grants received by the individual for payment of costs of attendance that are administered and processed by the institution during the calendar year; and (c) the amount of any adjustments to the aggregate amounts reported under (a) or (b) with respect to the individual for a prior calendar year.

Effective Date

The provision applies to expenses paid or assessed after December 31, 2002 (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

**PART SEVEN: VICTIMS OF TERRORISM TAX RELIEF ACT
OF 2001 (PUBLIC LAW 107-134)¹⁸¹**

**I. RELIEF PROVISIONS FOR VICTIMS OF SPECIFIC
TERRORIST ATTACKS**

A. Reasons for Change¹⁸²

***Relief for victims of April 19, 1995, and September 11, 2001,
terrorist attacks***

The Congress believed that it was appropriate to provide tax relief to the victims of the terrorist attacks against the United States on September 11, 2001, and April 19, 1995 (the bombing of the Alfred P. Murrah Federal Building in Oklahoma City).

Under present and prior law, tax relief from income and employment taxes is afforded to members of the Armed Forces on death. Present and prior law also provided a reduction in Federal estate tax for members of the U.S. Armed Forces who are killed in action while serving in a combat zone. The Congress believed that similar tax benefits should be afforded to victims of the September 11, 2001, and April 19, 1995, terrorist attacks.

For the victims of the September 11, 2001, terrorist attacks, the Congress also found it appropriate to provide an exclusion from gross income for amounts that would otherwise be includible in gross income by reason of indebtedness of a individual that is discharged as a result of the individual's death in the terrorist attack. In light of the numerous charitable organizations making payments as a result of the September 11, 2001, terrorist attacks, the Congress believed it appropriate to provide that qualified payments made by charitable organizations are exempt payments.

¹⁸¹H.R. 2884. The bill was referred to the House Committee on Ways and Means. The bill was discharged from committee and considered by the House under unanimous consent. The House passed the bill on September 13, 2001. The bill was referred to the Senate Committee on Finance. The bill was discharged from the Finance Committee by unanimous consent. The Senate passed the bill with amendment on November 16, 2001 by unanimous consent. The House passed the bill with the Senate amendment and a further House amendment on December 13, 2001. The Senate concurred to the House bill with a further amendment in the nature of a substitute on December 20, 2001 by unanimous consent. The House agreed without objection to the bill on December 20, 2001. The bill was signed by the President on January 23, 2002.

¹⁸²The legislative history for H.R. 2884 does not include reasons for change. The reasons for change reported here are adapted from the Description of the Economic Recovery and Assistance for American Workers Act of 2001—Technical Explanation of Provisions Approved by the Committee on November 8, 2001 (S. Prt. No. 107-49). The Senate Finance Committee produced this report in connection with H.R. 3090 which contained certain provisions similar to those enacted in Pub. L. No. 107-134.

B. Income Taxes of Victims of Terrorist Attacks (sec. 101 of the Act and sec. 692 of the Code)***Present and Prior Law***

An individual in active service as a member of the Armed Forces who dies while serving in a combat zone (or as a result of wounds, disease, or injury received while serving in a combat zone) is not subject to income tax or self-employment tax for the year of death (as well as for any prior taxable year ending on or after the first day the individual served in the combat zone) (section 692(a)(1)). Special computational rules apply in the case of joint returns. Military and civilian employees of the United States are entitled to a similar exemption if they die as a result of wounds or injury which was incurred outside the United States in terrorist or military action (section 692(c)).

The exemption applies not only to the tax liability of the individual attributable to income received before the date of death and reported on the decedent's final return. The exemption applies also to the liability of another person to the extent the liability is attributable to an amount received after the individual's death which would have been includable in the individual's income for the taxable year in which the date of death falls (determined as if the individual had survived).¹⁸³ For example, the individual's final wage payment, or interest or dividends payable in the year of death with respect to the individual's assets, are exempt from income tax when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death).

This exemption is available for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury were incurred. Thus, for example, if someone is injured and dies in the year the injury occurred, the exemption applies for the year of death and the prior taxable year. Similarly, if someone is injured and dies two years later, this exemption is available for the taxable year of death as well as the three prior taxable years (i.e., the year preceding the injury, the year of the injury, and the two years following the year of the injury).

Explanation of Provision***Application of relief to victims of September 11, 2001, April 19, 1995, and anthrax attacks***

The Act extends relief similar to the prior and present-law treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States to individuals who die as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, and individuals who die as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002. Under the Act, such individuals generally are exempt from income

¹⁸³Treas. Reg. sec. 1.692-1(a)(2)(ii).

tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury occurred.¹⁸⁴ The exemption applies to these individuals whether killed in an attack (e.g., in the case of the September 11, 2001, attack in one of the four airplanes or on the ground) or in rescue or recovery operations.

The provision provides a minimum tax relief benefit of \$10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. If an eligible individual's income tax for years eligible for the exclusion under the provision is less than \$10,000, the individual is treated as having made a tax payment for such individual's last taxable year in an amount equal to the excess of \$10,000 over the amount of tax not imposed under the provision.

Subject to rules prescribed by the Secretary, the exemption from tax does not apply to the tax attributable to: (1) deferred compensation which would have been payable after death if the individual had died other than as a specified terrorist victim, or (2) amounts payable in the taxable year which would not have been payable in such taxable year but for an action taken after September 11, 2001. Thus, for example, the exemption does not apply to amounts payable from a qualified plan or individual retirement arrangement to the beneficiary or estate of the individual. Similarly, amounts payable only as death or survivor's benefits pursuant to deferred compensation preexisting arrangements that would have been paid if the death had occurred for another reason are not covered by the exemption. In addition, if the individual's employer makes adjustments to a plan or arrangement to accelerate the vesting of restricted property or the payment of nonqualified deferred compensation after the date of the particular attack, the exemption does not apply to income received as a result of that action.¹⁸⁵ Also, if the individual's beneficiary cashed in savings bonds of the decedent, the exemption does not apply. On the other hand, the exemption does apply, for example, to a final paycheck of the individual or dividends on stock held by the individual when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death). The exemption also applies to payments of an individual's accrued vacation and accrued sick leave.

The provision does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

Simplified refund procedures

It is intended that the Secretary will establish procedures to simplify refunds of these amounts, including expanding the directions in Revenue Procedure 85-35 to include specific instructions for Form 1041.

¹⁸⁴The Act does not provide relief from self-employment tax liability.

¹⁸⁵Such amounts may, however, be excludable from gross income under the death benefit exclusion provided in section 102 of the Act.

Effective Date

The provision is effective for taxable years ending before, on, or after September 11, 2001.

A special rule extends the period of limitations to permit the filing of a claim for refund resulting from this provision until one year after the date of enactment, if that period would otherwise have expired before that date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$151 million in 2002 and \$20 million in 2003.

C. Exclusion of Certain Death Benefits (sec. 102 of the Act and sec. 101 of the Code)***Present and Prior Law***

In general, gross income includes income from whatever source derived (section 61), including payments made as a result of the death of an individual. Certain exceptions to this general rule of inclusion may apply to such payments in certain cases.

For example, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injury (including death) or sickness (section 104(a)(2)). Further, gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract if such amounts are paid by reason of the death of the insured (section 101(a)).

In addition, gifts are not includable in gross income (section 102). However, with very limited exceptions, payments made by an employer to, or for the benefit of, an employee are not excluded from gross income as gifts (section 102(c)). In business contexts in which section 102(c) does not apply, payments are excludable as gifts only if objective inquiry demonstrates that the payments were made out of “detached and disinterested generosity” and not in return for past or future services or from motives of anticipated benefit.¹⁸⁶

Explanation of Provision

The Act generally provides an exclusion from gross income for amounts received if such amounts are paid by an employer (whether in a single sum or otherwise)¹⁸⁷ by reason of the death of an employee who dies as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002. Subject to rules prescribed by the Secretary, the exclusion does not apply to amounts that would have been payable if the individual had died for a reason other than the attack. For example, the provision does not apply to payments by an employer under a nonqualified deferred

¹⁸⁶ *Comm'r v. Duberstein*, 363 U.S. 278 (1960).

¹⁸⁷ Thus, for example, payments made over a period of years could qualify for the exclusion.

compensation plan¹⁸⁸ to the extent that the amounts would have been payable if the death had occurred for another reason. The exclusion does apply, however, to death benefits provided under a qualified plan that satisfy the incidental benefit rule.

For purposes of the exclusion, self-employed individuals are treated as employees. Thus, for example, payments by a partnership to the surviving spouse of a partner who died as a result of the September 11, 2001, attacks may be excludable under the provision.

The provision does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

No change to prior and present law is intended as to the deductibility of death benefits paid by the employer or otherwise merely because the payments are excludable by the recipient. Thus, it is intended that payments excludable from income under the provision are deductible to the same extent they would be if they were includable in income.

The Act is not intended to narrow the scope of any applicable exclusion under prior or present law. Accordingly, payments that are not specifically excludable under the Act remain excludable to the same extent provided under prior and present law.

In connection with the September 11, 2001, terrorist attacks, insurance companies may pay death benefits under a life insurance contract even if the contract terms provide for an exclusion for death occurring as a result of an act of terrorism or act of war. It is understood that such a death benefit payment would fall within the prior and present-law exclusion (under section 101(a)) for payments made under the contract if it otherwise meets the requirements of the prior and present-law exclusion.

Effective Date

The provision is effective for taxable years ending before, on, or after September 11, 2001.

A special rule extends the period of limitations to permit the filing of a claim for refund resulting from this provision until one year after the date of enactment, if that period would otherwise have expired before that date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$25 million annually in 2002 and 2003.

D. Estate Tax Reduction (sec. 103 of the Act and sec. 2201 of the Code)

Present and Prior Law

Prior and present law provides a reduction in Federal estate tax for taxable estates of U.S. citizens or residents who are active

¹⁸⁸The provision does not apply to amounts received under a qualified plan because such payments are not made by the employer.

members of the U.S. Armed Forces and who are killed in action while serving in a combat zone (section 2201). This provision also applies to active service members who die as a result of wounds, disease, or injury suffered while serving in a combat zone by reason of a hazard to which the service member was subjected as an incident of such service.

In general, the effect of section 2201 is to replace the Federal estate tax that would otherwise be imposed with a Federal estate tax equal to 125 percent of the maximum State death tax credit determined under section 2011(b). Credits against the tax, including the unified credit of section 2010 and the State death tax credit of section 2011, then apply to reduce (or eliminate) the amount of the estate tax payable.

The reduction in Federal estate taxes under section 2201 is equal in amount to the "additional estate tax" with respect to the estates of decedents dying before January 1, 2005. The additional estate tax is the difference between the Federal estate tax imposed by section 2001 and 125 percent of the maximum State death tax credit determined under section 2011(b). With respect to the estates of decedents dying after December 31, 2004, section 2201 provides that the additional estate tax is the difference between the Federal estate tax imposed by section 2001 and 125 percent of the maximum state death tax credit determined under section 2011(b) as in effect prior to its repeal by the Economic Growth and Tax Relief Reconciliation Act of 2001.

Explanation of Provision

The Act generally treats individuals who die from wounds or injury incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002, in the same manner as if they were active members of the U.S. Armed Forces killed in action while serving in a combat zone or dying as a result of wounds or injury suffered while serving in a combat zone for purposes of section 2201. Consequently, the estates of these individuals are eligible for the reduction in Federal estate tax provided by section 2201. The provision does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

The Act also changes the general operation of section 2201, as it applies to both the estates of service members who qualify for special estate tax treatment under present and prior law and to the estates of individuals who qualify for the special treatment only under the Act. Under the Act, the Federal estate tax is determined in the same manner for all estates that are eligible for Federal estate tax reduction under section 2201. In addition, the executor of an estate that is eligible for special estate tax treatment under section 2201 may elect not to have section 2201 apply to the estate. Thus, in the event that an estate may receive more favorable treatment without the application of section 2201 in the year of death than it would under section 2201, the executor may elect not to apply the provisions of section 2201, and the estate tax owed (if

any) would be determined pursuant to the generally applicable rules.

Under the Act, section 2201 no longer reduces Federal estate tax by the amount of the additional estate tax. Instead, the Act provides that the Federal estate tax liability of eligible estates is determined under section 2001 (or section 2101, in the case of decedents who were neither residents nor citizens of the United States), using a rate schedule that is equal to 125 percent of the present-law maximum State death tax credit amount. This rate schedule is used to compute the tax under section 2001(b) or section 2101(b) (i.e., both the tentative tax under section 2001(b)(1) and section 2101(b), and the hypothetical gift tax under section 2001(b)(2) are computed using this rate schedule). As a result of this provision, the estate tax is unified with the gift tax for purposes of section 2201 so that a single graduated (but reduced) rate schedule applies to transfers made by the individual at death, based upon the cumulative taxable transfers made both during lifetime and at death.

In addition, while the Act provides an alternative reduced rate table for purposes of determining the tax under section 2001(b) or section 2101(b), the amount of the unified credit nevertheless is determined as if section 2201 did not apply, based upon the unified credit as in effect on the date of death. For example, in the case of victims of the September 11, 2001, terrorist attack, the applicable unified credit amount under section 2010(c) would be determined by reference to the actual section 2001(c) rate table.

As a conforming amendment, the Act repeals section 2011(d) because it no longer will have any application to taxpayers.

Effective Date

The provision applies to estates of decedents dying on or after September 11, 2001, or, in the case of victims of the Oklahoma City terrorist attack, estates of decedents dying on or after April 19, 1995.

A special rule extends the period of limitations to permit the filing of a claim for refund resulting from this provision until one year after the date of enactment, if that period would otherwise have expired before that date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$3 million in 2002, \$45 million in 2003, \$8 million in 2004, and less than \$1 million annually in 2005–2010.

E. Payments by Charitable Organizations Treated as Exempt Payments (sec. 104 of the Act and secs. 501 and 4941 of the Code)

Present and Prior Law

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible (section 170). Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organiza-

tions may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation (section 4941). For example, it is self-dealing if the income or assets of a private foundation are transferred to, or used by or for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous.

Explanation of Provision

In light of the extraordinary distress caused by the attacks on the United States of September 11, 2001, and the subsequent attacks involving anthrax, the Act provides that organizations described in section 501(c)(3) that make payments by reason of the death, injury, wounding, or illness of an individual incurred as a result of the September 11, 2001, attacks, or as a result of an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002, are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization's exemption. This rule applies provided that the organization makes the payments in good faith using a reasonable and objective formula which is consistently applied. As under prior and present law, such payments must be for public and not private benefit and therefore must serve a charitable class. For example, under this standard, a charitable organization that assists families of firefighters killed in the line of duty could make a pro-rata distribution to the families of firefighters killed in the attacks, even though the specific financial needs of each family are not directly considered. Similarly, if the amount of a distribution is based on the number of dependents of a charitable class of persons killed in the attacks and this standard is applied consistently among distributions, the specific needs of each recipient do not have to be taken into account. However, it would not be appropriate for a charity to make pro-rata payments based on the recipients' living expenses before September 11 if the result generally is to provide significantly greater assistance to persons in a better position to provide for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it would not, under the statutory standard, be a reasonable formula for distributing assistance in an equitable manner. Similarly, although specific assessments of need are not required, the Act does not change the other substantive standards for exemption under section 501(c)(3), including the prohibition on private inurement and the need for a charitable class. It is impossible to list or anticipate the kinds of payments that meet the statutory test, but, in general, charities that make distributions in good faith using a reasonable and objec-

tive formula will be treated as acting consistently with exempt purposes. A charity that makes payments subject to this provision should indicate clearly on the charity's information return, for example by notation at the top of the relevant page of the return, that the charity relied on this provision in making distributions. The Act also provides that if a private foundation makes payments under the conditions described above, the payment is not treated as made to a disqualified person for purposes of section 4941.

For charities making payments in connection with the September 11 attacks or attacks involving anthrax, but not in reliance on this provision, prior law rules apply. It is expected that, because of the severity of distress arising out of the September 11 and anthrax attacks and the extensive variety of needs that the thousands of victims and their family members may have, a wide array of expenses will be consistent with operation for exclusively charitable purposes. For instance, payments to permit a surviving spouse with young children to remain at home with the children rather than being forced to enter the workplace seem to be appropriate to maintain the psychological well-being of the entire family. Similarly, assistance with elementary and secondary school tuition to permit a child to remain in the same educational environment seems to be appropriate, as does assistance needed for higher education. Assistance with rent or mortgage payments for the family's principal residence or car loans also seems to be appropriate to forestall losses of a home or transportation that would cause additional trauma to families already suffering. Other types of assistance that the scope of the tragedy makes it difficult to anticipate may also serve a charitable purpose.

Effective Date

The provision applies to payments made on or after September 11, 2001.

Revenue Effect

The provision is estimated to have a negligible impact on Federal fiscal year budget receipts.

F. Exclusion for Certain Cancellations of Indebtedness (sec. 105 of the Act)

Present and Prior Law

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income (except for discharges of real property business indebtedness), taxpayers generally exclude discharge of indebtedness from income but reduce tax attributes by the amount of the discharge of indebtedness. The amount of discharge of indebtedness excluded from income by an insolvent debtor or not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. For all taxpayers, the amount of dis-

charge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Present law generally requires “applicable entities” to file information returns with the IRS regarding any discharge of indebtedness in the amount of \$600 or more (section 6050P). This requirement applies without regard to whether the debtor is subject to tax on the discharged indebtedness.¹⁸⁹ The term “applicable entities” includes: (1) any financial institution (as described in section 581 (relating to banks) or section 591(a) (relating to savings institutions)); (2) any credit union; (3) any corporation that is a direct or indirect subsidiary of an entity described in (1) or (2) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; (4) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, certain other Federal executive agencies, and any successor or subunit of any of them; (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. section 3701(a)(4)); and (6) any other organization a significant trade or business of which is the lending of money. Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers generally is \$50 per failure, subject to a maximum of \$100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Explanation of Provision

The Act provides that gross income does not include any amount realized from the discharge (in whole or in part) of indebtedness if the indebtedness is discharged by reason of the death of an individual incurred as a result of the September 11, 2001, attacks, or as a result of a terrorist attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002. In all cases, the provision applies only if the indebtedness is discharged because the individual died as a result of one the attacks. Therefore, except in circumstances that indicate the taxpayer was financially dependent upon an individual who died in one of the attacks, it is intended that the provision generally applies only if the taxpayer was, or became, an obligor or co-obligor with respect to indebtedness of an individual who died as a result of one of the attacks (e.g., the surviving spouse or estate of the individual).

The Act also provides that the information return filing requirements that otherwise apply to discharges of indebtedness do not apply with respect to any discharge of indebtedness that is excluded from gross income under this provision.

¹⁸⁹Treas. Reg. sec. 1.6050P-1(a)(3).

Effective Date

This provision applies to discharges made on or after September 11, 2001, and before January 1, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$6 million in 2002.

II. OTHER RELIEF PROVISIONS

A. Reasons for Change¹⁹⁰

General relief for victims of disaster and terroristic or military actions

In addition to the specific tax relief provided to the victims of the terrorist acts of September 11, 2001, and April 19, 1995, the Congress found it appropriate to provide general relief for victims of disaster and terrorist or military actions. The Congress found it necessary to clarify and expand prior law.

The Congress believed it necessary to clarify that disaster relief payments are excludable from income. Because many forms of disasters make it difficult for taxpayers to meet required tax deadlines, the Congress believed it appropriate to grant authority to the Internal Revenue Service to postpone certain deadlines. Additionally, the Congress found it beneficial to establish an Internal Revenue Service disaster response team to assist taxpayers in resolving Federal tax matters associated with or resulting from a disaster. To provide additional relief and clarification to victims of terrorist activity, the Congress also believed it appropriate to clarify and expand prior law regarding death and disability payments made in connection with terrorist or military action.

The Congress also found it necessary to clarify that the special deposit rules under the Air Transportation Safety and System Stabilization Act¹⁹¹ do not apply to employment taxes.

B. Exclusion of Disaster Relief Payments (sec. 111 of the Act and new sec. 139 of the Code)

Present and Prior Law

Taxation of disaster relief payments

Gross income includes all income from whatever source derived unless a specific exception applies (section 61). There is no specific statutory exclusion from income for disaster payments. However, various types of disaster payments made to individuals have been excluded from gross income under a general welfare exception.¹⁹² The exception has been held to exclude from income payments made under legislatively provided social benefit programs for the promotion of the general welfare. The general welfare exception generally applies if the payments (1) are made from a govern-

¹⁹⁰The legislative history for H.R. 2884 does not include reasons for change. The reasons for change reported here are adapted from the Technical Explanation to the Economic Recovery and Assistance for American Workers Act of 2001 (S. Prt. No. 107-49). The Senate Finance Committee produced this report in connection with H.R. 3090 that contained certain provisions similar to those enacted in Pub. L. No. 107-134.

¹⁹¹Pub. L. No. 107-42.

¹⁹²Rev. Rul. 98-19, 1998-1 C.B. 840; Rev. Rul. 76-144, 1976-1 C.B. 17.

mental general welfare fund, (2) are for the promotion of the general welfare (on the basis of need and not to all residents), and (3) are made without respect to services rendered by the recipient. The exclusion generally applies to payments for food, medical, housing, personal property, transportation, and funeral expenses.

The general welfare exception generally does not apply to payments in the nature of income replacement, such as payments to individuals for lost wages or unemployment compensation or payments in the nature of income replacement to businesses.¹⁹³ Income replacement payments are includable in gross income, unless another exception applies.

Disaster relief payments may be excludable under other provisions. For example, payments made by charitable relief organizations may be excluded from the gross income of the recipients as gifts. Payments made in a business context generally are not treated as gifts. Factual issues may arise as to whether a payment in the context of a business relationship is a gift or taxable compensation for services. In general, payments made by an employer to, or for the benefit of, an employee are not excluded from gross income as gifts (section 102(c)).

Under prior and present law, gross income generally does not include payments received as damages (other than punitive damages) on account of personal physical injury (including death) or sickness (section 104(a)(2)). Such payments are excluded from gross income regardless of whether received by suit or agreement and whether received as a lump sum or as periodic payments.

Section 406 of the Air Transportation Safety and System Stabilization Act provides for the payment of compensation for eligible individuals who suffered physical harm or death as a result of the terrorist-related aircraft crashes of September 11, 2001. There is no statutory provision specifically addressing the taxation of such compensation; however, such compensation may be excludable from income under generally applicable Code provisions (e.g., section 104).

Rules relating to charitable organizations

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible (section 170). Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation (section 4941). For example, it is self-dealing if

¹⁹³ IRS Publication 547 (Casualties, Disasters, and Thefts), page 5 (revised December 2000); Rev. Rul. 91-55, 1991-2 C.B. 321; Rev. Rul. 73-408, 1973-2 C.B. 15.

the income or assets of a private foundation are transferred to, or used by or for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous. Private foundations also are subject to excise taxes on taxable expenditures (section 4945). For example, it is a taxable expenditure if a private foundation pays an amount that does not further certain charitable purposes, or makes a grant to an individual for educational or other similar purposes without following certain procedures.

Explanation of Provision

Taxation of disaster relief payments

The Act clarifies that any amount received as payment under section 406 of the Air Transportation Safety and System Stabilization Act is excludable from gross income. In addition, the Act provides a specific exclusion from income for qualified disaster relief payments. No inference is intended as to the taxability of such payments under prior law. In addition, the provision is not intended to preclude the exclusion of other types of payments under the general welfare exception or other Code provisions.

Qualified disaster relief payments include payments, from any source, to, or for the benefit of, an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster. Personal, family, and living expenses are intended to have the same meaning as when used in section 262. Personal expenses include personal property expenses.

Qualified disaster relief payments also include payments, from any source, to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence, or for the repair or replacement of its contents, to the extent that the need for the repair, rehabilitation, or replacement is attributable to a qualified disaster. For purposes of determining the tax basis of a rehabilitated residence, it is intended that qualified disaster relief payments be treated in the same manner as amounts received on an involuntary conversion of a principal residence under section 121(d)(5) and sections 1033(b) and (h). A residence is not precluded from being a personal residence solely because the taxpayer does not own the residence; a rented residence can qualify as a personal residence.

Qualified disaster relief payments also include payments by a person engaged in the furnishing or sale of transportation as a common carrier on account of death or personal physical injuries incurred as a result of a qualified disaster. Thus, for example, payments made by commercial airlines to families of passengers killed as a result of a qualified disaster would be excluded from gross income.¹⁹⁴

Qualified disaster relief payments also include amounts paid by a Federal, State or local government in connection with a qualified disaster in order to promote the general welfare. As under the gen-

¹⁹⁴The exclusion from income applies irrespective of section 104(a)(2). As previously discussed, no inference is intended that payments excludable under section 139 would not be otherwise excludable under another Code provision.

eral welfare exception, the exclusion does not apply to payments in the nature of income replacement, such as payments to individuals of lost wages, unemployment compensation, or payments in the nature of business income replacement.

Qualified disaster relief payments do not include payments for any expenses compensated for by insurance or otherwise. No change from prior law is intended as to the deductibility of qualified disaster relief payments, made by an employer or otherwise, merely because the payments are excludable by the recipients. Thus, it is intended that payments excludable from income under the provision are deductible to the same extent they would be if they were includable in income. In addition, in light of the extraordinary circumstances surrounding a qualified disaster, it is anticipated that individuals will not be required to account for actual expenses in order to qualify for the exclusion, provided that the amount of the payments can be reasonably expected to be commensurate with the expenses incurred.

Particular payments may come within more than one category of qualified disaster relief payments; the categories are not intended to be mutually exclusive. Qualified disaster relief payments also are excludable for purposes of self-employment taxes and employment taxes. Thus, no withholding applies to qualified disaster relief payments.

Under the Act, a qualified disaster includes a disaster which results from a terroristic or military action (as defined in section 692(c)(2), as amended by the Act), a Presidentially declared disaster, a disaster which results from an accident involving a common carrier or from any other event which would be determined by the Secretary to be of a catastrophic nature, or, for purposes of payments made by a Federal, State or local government, a disaster designated by Federal, State or local authorities to warrant assistance.

The exclusion from income under section 139 does not apply to any individual identified by the Attorney General to have been a participant or conspirator in the terrorist-related aircraft crashes of September 11, 2001, or any other terrorist attack, or to a representative of such individual.

Rules applicable to charitable organizations making disaster relief payments

Recognizing that employers and employees may also contribute to section 501(c)(3) organizations that make disaster relief payments, clarification of the type of disaster relief grants such organizations may make consistent with exempt purposes to assist individuals in distress as a result of the September 11 attacks, and more generally, may be helpful. Because the Act provides a special rule for certain payments made by reason of death, injury, wounding, or illness of an individual as a result of the September 11 attacks, and certain attacks involving anthrax, the following discussion relates to disaster relief generally.

Generally, a charitable organization must serve a public rather than a private interest. Providing assistance to relieve distress for individuals suffering the effects of a disaster generally serves a public rather than a private interest if the assistance benefits the

community as a whole, or if the recipients otherwise lack the resources to meet their physical, mental and emotional needs. Such assistance could include cash grants to provide for food, clothing, housing, medical care, funeral costs, transportation, education and other needs. All such grants must be need-based, taking into account the family's financial resources and their physical, mental and emotional well-being.

Charitable organizations generally are in the best position to determine the type and amount of, and appropriate beneficiaries for, disaster relief. Accordingly, it is expected that the Secretary will presume that a charity providing cash assistance in good faith to victims (and their family members) of a qualified disaster is acting consistent with the requirements of section 501(c)(3) if the class of beneficiaries is sufficiently large or indefinite and the charity can demonstrate that it is applying consistent, objective criteria for assessing need.

In addition to the rules described above that are applicable to all charities, special rules apply with respect to disaster relief provided by private foundations controlled by an employer. In such cases, clarification of the appropriate treatment of the foundation and the payments may be helpful. In general, a private foundation that is established and controlled by an employer violates the requirements of section 501(c)(3) if it provides benefits to a class of beneficiaries composed exclusively of the employer's employees, and such benefits are a form of compensation. The IRS recently held in a private letter ruling,¹⁹⁵ and in similar rulings, that a private foundation that is established, funded and controlled by a particular employer for the purpose of providing disaster relief for employees of a particular employer does not qualify as a charitable organization under section 501(c)(3), because the foundation is not operated solely for charitable purposes and is providing a benefit on behalf of the employer in violation of the prohibition on private inurement. Although private letter rulings do not constitute precedent for other taxpayers, considerable uncertainty exists regarding IRS' position relating to employer-controlled private foundations making disaster relief payments to employee-beneficiaries.

If payments in connection with a qualified disaster are made by a private foundation to employees (and their family members) of an employer that controls the foundation, the presumption that the charity acts consistently with the requirements of section 501(c)(3) applies if the class of beneficiaries is large or indefinite and if recipients are selected based on an objective determination of need by an independent committee of the private foundation, a majority of the members of which are persons other than persons who are in a position to exercise substantial influence over the affairs of the controlling employer (determined under principles similar to those in effect under section 4958). The presumption does not apply to grants made to, or for the benefit of, a disqualified person or member of the selection committee. However, the absence of an independent selection committee does not necessarily mean that a foundation violates the requirements of section 501(c)(3). Other procedures and standards may be adequate substitutes to ensure that

¹⁹⁵Priv. Ltr. Rul. 199914040.

any benefit to the employer is incidental and tenuous. Similarly, providing need-based payments to employees and their survivors in response to a disaster other than a qualified disaster may well further charitable purposes consistent with the requirements of section 501(c)(3).

It is intended that an employer-controlled private foundation is not providing an inappropriate benefit and is not disqualified from exemption under section 501(c)(3) if it makes a payment to an employee or a family member of an employee (who is employed by an employer who controls the foundation) that relieves distress caused by a qualified disaster as defined under section 139, provided that it awards grants based on an objective determination of need using either an independent selection committee or adequate substitute procedures, as described above. It is further intended that section 102(c) of the Code, which provides that a transfer from an employer to, or for the benefit of, an employee generally is not excludable from income as a gift, does not apply to such payments. It is further expected that the Service will reconsider the ruling position it has taken to ensure that private foundations established and controlled by employers will have appropriate guidance, consistent with the principles outlined above, on the circumstances under which they may provide disaster assistance in connection with a qualified disaster specifically to the employers' employees.

It is intended that the making by a private foundation of disaster relief payments that qualify for the presumption stated above (1) will not be treated as an act of self-dealing under section 4941 merely because the recipient is an employee (or family member of an employee) of a disqualified person with respect to the foundation, (2) will be treated as in furtherance of section 170(c)(2)(B) purposes, and (3) will be considered to meet the requirements of section 4945(g) to the extent that they apply. Moreover, contributions to a section 501(c)(3) organization administering relief in a manner outlined above (including those made by employers and any of their employees) are deductible under the generally applicable rules of section 170. Finally, it is confirmed that need-based payments made by an employer-controlled foundation to an individual for exclusively charitable purposes generally are excludable from the recipients' income as gifts.¹⁹⁶ Thus, such payments made by a foundation to relieve distress caused by a qualified disaster are excludable from the recipients' income regardless of whether they fall within the scope of section 139, or any other such provision of the Code providing for an exclusion. The IRS is directed to issue prompt guidance to taxpayers relating to the requirements applicable to private foundations making disaster assistance payments. The principles discussed above should apply to foundations and public charities providing relief in response to both the September 11, 2001, disaster and future qualified disasters.

Effective Date

The provision applies to taxable years ending on or after September 11, 2001.

¹⁹⁶See, e.g., Rev. Rul. 99-44, 1999-2 C.B. 549.

Revenue Effect

The provision is estimated to have a negligible impact on Federal fiscal year budget receipts.

C. Authority to Postpone Certain Deadlines and Required Actions (sec. 122 of the Act, sec. 7508A of the Code, and new sec. 518 and sec. 4002 of the Employee Retirement Income Security Act of 1974)

Present and Prior Law

In general

In general, the Secretary of the Treasury may prescribe regulations under which a period of up to 120 days may be disregarded for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, for any taxpayer determined by the Secretary to be affected by a Presidentially declared disaster (section 7508A).

The suspension of time may apply to the following acts:

- (1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);
- (2) Payment of any income, estate, or gift tax (except employment and withholding taxes);
- (3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
- (4) Allowance of a credit or refund of any tax;
- (5) Filing a claim for credit or refund of any tax;
- (6) Bringing suit upon any such claim for credit or refund;
- (7) Assessment of any tax;
- (8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
- (9) Collection of the amount of any liability in respect of any tax;
- (10) Bringing suit by the United States in respect of any liability in respect of any tax; and
- (11) Any other act required or permitted under the internal revenue laws specified in regulations prescribed by the Secretary of the Treasury.¹⁹⁷

Individuals may, if they choose, perform any of these acts during the period of suspension.

On September 13, 2001, the IRS issued Notice 2001-61 providing relief to taxpayers affected by the September 11, 2001, terrorist attack. Prior to issuance of this notice, the President had declared certain affected areas to be disaster areas. In addition, on September 14, 2001, the IRS issued Notice 2001-63 providing additional tax relief to taxpayers who found it difficult to meet their tax filing and payment obligations.

¹⁹⁷Treas. Reg. sec. 301.7508A-1(c)(1)(vii) states, with respect to this clause, that it encompasses "any other act specified in a revenue ruling, revenue procedure, notice, announcement, news release, or other guidance published in the Internal Revenue Bulletin."

Employee benefit plans

Questions have arisen about the scope of section 7508A in relation to employee benefit plans. Some acts related to employee benefit plans are not clearly covered by the suspension. For example, a plan sponsor or plan administrator may be required to provide a notice to plan participants or to make a plan contribution, or a plan participant may be required to make a benefit election or take a distribution under the plan. In addition, some acts related to employee benefit plans may be required or provided for under the Employee Retirement Income Security Act (“ERISA”) or under the terms of the plan, rather than under the Internal Revenue Code. For example, on September 14, 2001, the Department of Labor issued News Release No. 01–36, announcing that the Pension and Welfare Benefits Administration, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation were extending the deadline for filing Form 5500 and Form 5500–EZ.

Explanation of Provision***In general***

The Act redrafts section 7508A to expand its scope and to clarify its application. Specifically, the Act permits the Secretary to suspend the period of time under this provision for up to one year (increased from up to 120 days). The Act also clarifies that interest on underpayments may be waived or abated pursuant to section 7508A with respect to either a declared disaster or a terroristic or military action. The Act clarifies that the Secretary of the Treasury has the authority to postpone actions pursuant to section 7508A in response to a terroristic or military action, regardless of whether a disaster area has been declared by the President in connection with the action. The Act facilitates the prompt issuance of guidance by the Secretary of the Treasury with respect to section 7508A by removing the requirement that regulations be published listing the scope of additional actions that may be postponed pursuant to section 7508(a)(1)(K); accordingly, the Secretary may provide authoritative guidance via a notice or other mechanism of the Secretary’s choice that may be issued more rapidly. It is intended that the Secretary construe this authority as broadly as is necessary and appropriate to respond to specific disasters or terroristic or military actions. The authority to postpone “any . . . act” is sufficiently broad to encompass, for example, specific deadlines enumerated in the Code, such as those in section 1031 (relating to the exchange of property held for productive use or investment). Similarly, it is intended that the Secretary utilize this authority to address issues that arise from the discovery of tax information subsequent to the filing of a tax return that would affect the tax liability reported on that return.

Employee benefit plans

The Act expands and clarifies the scope of the deadlines and required actions that may be postponed pursuant to section 7508A. The Act provides that the Secretary of the Treasury may prescribe a period of up to one year which may be disregarded in determining the date by which any action by a pension or other em-

ployee benefit plan, or by a plan sponsor, administrator, participant, beneficiary or other person would be required or permitted to be completed. The Act provides similar authority to the Secretary of Labor and the Pension Benefit Guaranty Corporation with respect to actions within their respective jurisdictions.

The Act is not limited to actions under the Internal Revenue Code. Accordingly, actions under ERISA or under the terms of the plan come within the scope of this provision. Acts performed within the extended period are considered timely under the Internal Revenue Code, ERISA, and the plan. In addition, a plan is not treated as operating in a manner inconsistent with its terms or in violation of its terms merely because acts provided for under the plan are performed during the extended period.

Examples of acts covered by the provision include: (1) the filing of a form with the IRS, Department of Labor or the Pension Benefit Guaranty Corporation, (2) an employer's contribution to the plan of required quarterly amounts for the current year or the prior year minimum funding amounts, (3) the filing of an application for a waiver of the minimum funding standard, (4) the payment of premiums to the Pension Benefit Guaranty Corporation, (5) a participant's election of a form of benefits under a plan, (6) the plan administrator's distribution of benefits in accordance with a participant's election, (7) notice to an employee of eligibility for continuation coverage under a group health plan, and (8) an employee's election of continuation coverage.

Effective Date

The provision applies to disasters and terroristic or military actions occurring on or after September 11, 2001, with respect to any action of the Secretary of the Treasury, the Secretary of Labor, or the Pension Benefit Guaranty Corporation on or after the date of the enactment.

Revenue Effect

The provision is estimated to have a negligible impact on Federal fiscal year budget receipts.

D. Application of Certain Provisions to Terroristic or Military Actions (sec. 113 of the Act and secs. 104 and 692 of the Code)

Present and Prior Law

Taxation of disability income of U.S. employees related to terrorist activity outside the United States

Gross income does not include amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terrorist attack (as determined by the Secretary of State) which occurred while the individual was performing official duties as an employee of the United States outside the United States (section 104(a)(5)).

Income tax relief for military and civilian U.S. employees who die as a result of terrorist activity outside the United States

Military and civilian employees of the United States who die as a result of wounds or injury incurred outside the United States in a terroristic or military action are not subject to income tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury were incurred. Accordingly, if such an individual is injured and dies in the same taxable year, this exemption from income tax is available for the taxable year of death as well as the prior taxable year.

Explanation of Provision

Taxation of disability income related to terrorist activity

The Act expands the present and prior-law exclusion from gross income for disability income of U.S. civilian employees attributable to a terrorist attack outside the United States to apply to disability income received by any individual attributable to a terroristic or military action.

Income tax relief for individuals who die as a result of terrorist activity

The Act extends the income tax relief provided under present and prior law to U.S. military and civilian personnel who die as a result of terroristic activity or military action outside the United States to such personnel regardless of where the terroristic activity or military action occurred.

Effective Date

The provision is effective for taxable years ending on or after September 11, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$2 million annually in 2002 and 2003, \$1 million annually in 2004 and 2005, and less than \$500,000 annually in 2006–2012.

E. Clarification that the Special Deposit Rules Provided Under the Air Transportation Safety and Stabilization Act Do Not Apply to Employment Taxes (sec. 114 of the Act and sec. 301 of the Air Transportation Safety and Stabilization Act)

Present and Prior Law

Section 301 of the Air Transportation Safety and System Stabilization Act¹⁹⁸ provides a special rule for the deposit of certain taxes. If a deposit of these taxes was required to be made after September 10, 2001, and before November 15, 2001, they are treat-

¹⁹⁸Pub. L. No. 107–42.

ed as timely made if deposited by November 15, 2001. The Secretary of the Treasury is given the authority to extend this deadline further, but no later than January 15, 2002. For eligible air carriers, the special deposit rules are applicable to the excise taxes imposed on air travel. The special deposit rules were also applied inadvertently to the deposit of the following employment taxes: both the employer and employee portions of FICA, railroad retirement taxes, and income taxes withheld by employers from employees.

Explanation of Provision

The applicability of these special deposit rules to employment taxes is repealed. The applicability of these special deposit rules to excise taxes is unaffected. It is intended that no penalties be imposed with respect to taxes that were not deposited timely in reliance on the provisions of the Air Transportation Safety and System Stabilization Act prior to the enactment of this provision.

Effective Date

The provision is effective as if included in section 301 of the Air Transportation Safety and System Stabilization Act.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

F. Treatment of Purchase of Structured Settlements (sec. 115 of the Act and new sec. 5891 of the Code)

Present and Prior Law

Present and prior law provide tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

An exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (section 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that: (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(1) or (2) as workmen's compensation for personal injuries or sickness, or as damages on account of personal physical injuries or physical sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets

statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (section 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (section 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity that funds the liability to pay damages, generally is subject to tax.

The exclusion for recipients of the periodic payments received under a structured settlement arrangement as damages for personal physical injuries or physical sickness can be contrasted with the treatment of investment earnings that are not paid as damages. If a recipient of damages chooses to receive a lump sum payment (excludable from income under section 104), and then to invest it himself, generally the earnings on the investment are includable in income. For example, if the recipient uses the lump sum to purchase an annuity contract providing for periodic payments, then a portion of each payment under the annuity contract is includable in income, and the balance is excludable under present-law rules based on the ratio of the individual's investment in the contract to the expected return on the contract (section 72(b)).

The payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient (section 130). Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain "factoring" companies in exchange for their payment streams. The tax effect on the parties of these transactions may not have been completely clear under prior law.

Explanation of Provision

The provision generally imposes an excise tax on any person who acquires certain payment rights under a structured settlement arrangement from a structured settlement recipient for consideration. The amount of the excise tax is 40 percent of the excess of: (1) the undiscounted amount of the payments being acquired, over (2) the total amount actually paid to acquire them.

The 40-percent excise tax does not apply, however, if the transfer is approved in advance in a final order, judgment or decree that: (1) finds that the transfer does not contravene any Federal or State statute or the order of any court or responsible administrative authority; (2) finds that the transfer is in the best interest of the payee, taking into account the welfare and support of the payee's dependents; and (3) is issued under an applicable State statute by a court or is issued by the responsible administrative authority. Rules are provided for determining the applicable State statute.

The provision also provides that the acquisition transaction does not affect the application of certain present-law rules, if those rules were satisfied at the time the structured settlement was entered into. The rules are section 130 (relating to an exclusion from gross income for personal injury liability assignments), section 72 (relating to annuities), sections 104(a)(1) and (2) (relating to an exclusion for amounts received under workers' compensation acts and for damages on account of personal physical injuries or physical sickness), and section 461(h) (relating to the time of economic performance in determining the taxable year of a deduction).

Effective Date

The provision generally is effective for acquisition transactions entered into on or after 30 days following enactment. A transition rule applies during the period from that date to July 1, 2002. Under the transition rule, if no applicable State law (relating to the best interest of the payee) applies to a transfer during that period, then the exception from the 40 percent excise tax is available without the otherwise required court (or administrative) order, provided certain disclosure requirements are met. Under the transition rule, the person acquiring the structured settlement payments is required to disclose in advance to the payee: (1) the amounts and due dates of the payments to be transferred; (2) the aggregate amount to be transferred; (3) the consideration to be received by the payee; (4) the discounted present value of the transferred payments; and (5) the expenses to be paid by the payee or deducted from the payee's proceeds.

The provision providing that the acquisition transaction does not affect the application of certain present-law rules is effective for transactions entered into before, on or after the 30th day following enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than \$500,000 annually in 2002 through 2005, to reduce Federal fiscal year budget receipts by less than \$500,000 in 2006, and to reduce Federal fiscal year budget receipts by \$1 million annually in 2007 through 2012.

G. Personal Exemption Deduction for Certain Disability Trusts (sec. 116 of the Act and sec. 642 of the Code)

Present and Prior Law

Present and prior law generally provide a \$300 personal exemption for trusts that are required by their governing instruments to currently distribute all of their income. For other trusts, present and prior law generally provide a \$100 personal exemption. These deductions are in lieu of the personal exemption that generally is provided under section 151 for individuals (section 642(b)).

Under present law, a grantor who transfers property to a trust while retaining certain powers or interests over the trust is treated as the owner of the trust for income tax purposes under the so-called "grantor trust rules" (secs. 671–677). Similarly, a third party

who is not adverse to the grantor is treated as the owner of the trust under these rules to the extent that the third party is granted certain powers over the trust. If a grantor or third party is treated as the owner of a trust (a “grantor trust”), the income and deductions of the trust are included directly in the taxable income of the grantor or third party. Because the personal exemption under section 642(b) applies to income that is taxable to a trust (rather than a grantor or third party), the personal exemption under section 642(b) does not apply to grantor trusts.

Explanation of Provision

The Act provides that certain disability trusts may claim a personal exemption in an amount that is based upon the personal exemption provided for individuals under section 151(d), rather than the \$300 or \$100 personal exemption provided under present and prior law. The provision applies to taxable disability trusts described in 42 U.S.C. section 1396p(c)(2)(B)(iv) (relating to the treatment, for purposes of determining eligibility for medical assistance under the Social Security Act, of assets transferred to a trust established solely for the benefit of a disabled individual under 65 years of age).

The provision only applies to disability trusts the beneficiaries of which have been determined by the Commissioner of Social Security to be disabled (other than holders of a remainder or reversionary interest in the trust), within the meaning of 42 U.S.C. section 1382c(a)(3) (relating to the definition of a “disabled individual” for purposes of determining eligibility for Supplemental Security Income).

The provision applies if all of the beneficiaries of the trust at the end of the taxable year are determined under 42 U.S.C. section 1382c(a)(3) to be disabled for some portion of such year. Thus, a disability trust may claim the personal exemption under the provision even if one or more of the beneficiaries becomes no longer disabled during the taxable year. However, the trust may claim the personal exemption for the following taxable year only if such individual or individuals are no longer beneficiaries of the trust at the end of the following taxable year (i.e., all remaining beneficiaries of the trust at the end of the following taxable year are disabled or were disabled during some portion of such year). In the case of a disability trust with a single beneficiary, the trust may claim the personal exemption under the provision for the taxable year during which the beneficiary becomes no longer disabled, but not for subsequent taxable years.

The personal exemption provided for disability trusts under the provision is equal in amount to the section 151(d) personal exemption for unmarried individuals with no dependents and is subject to a phaseout, which is determined by reference to the phaseout of the personal exemption for such individuals under section 151(d)(3)(C)(iii). For purposes of computing the phaseout of the personal exemption under the provision, the adjusted gross income of the trust is determined by reference to section 67(e) (relating to the determination of adjusted gross income of estates and trusts for purposes of computing the 2-percent floor on miscellaneous itemized deductions).

The provision does not affect the determination of whether a disability trust is treated as a grantor trust under the present-law grantor trust rules, and does not change the inapplicability of the personal exemption under section 642(b) to grantor trusts. Thus, the provision does not apply to disability trusts that are treated as grantor trusts.

Effective Date

The provision applies to taxable years of disability trusts ending on or after September 11, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$3 million in 2002, \$4 million in 2003, \$5 million annually in 2004 and 2005, \$6 million annually in 2006 and 2007, \$7 million in 2008, \$8 million annually in 2009 and 2010, and \$9 million annually in 2011 and 2012.

III. DISCLOSURE OF TAX INFORMATION IN TERRORISM AND NATIONAL SECURITY INVESTIGATIONS (Sec. 201 of the Act and sec. 6103 of the Code)

Present and Prior Law

In general

Returns and return information are confidential (section 6103). A “return” is any tax return, information return, declaration of estimated tax, or claim for refund filed under the Code on behalf of or with respect to any person. The term return also includes any amendment or supplement, including supporting schedules, attachments, or lists, which are supplemental to or are part of a filed return. Return information is defined broadly. It includes the following information:

- A taxpayer’s identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;
- Whether the taxpayer’s return was, is being, or will be examined or subject to other investigation or processing;
- Any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense;
- Any part of any written determination or any background file document relating to such written determination which is not open to public inspection under section 6110;
- Any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to the agreement or any application for an advance pricing agreement; and
- Any agreement under section 7121 (relating to closing agreements), and any similar agreement, and any background information related to such agreement or request for such agreement (section 6103(b)(2)).

The term “return information” does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. “Taxpayer return information” means return information which is filed with, or furnished to, the Internal Revenue Service by or on behalf of the taxpayer to whom such return information relates.

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a

number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Recordkeeping and safeguard requirements also are imposed. These requirements establish a system of records to keep track of disclosure requests and disclosures and to ensure that the information is securely stored and that access to the information is restricted to authorized persons. These conditions and safeguards are intended to ensure that an individual's right to privacy is not unduly compromised and the information is not misused or improperly disclosed. The IRS also must submit reports to the Joint Committee on Taxation and to the public regarding requests for and disclosures made of returns and return information 90 days after the close of the calendar year (section 6103(p)(3)). Criminal and civil sanctions apply to the unauthorized disclosure or inspection of returns and return information (secs. 7213, 7213A, and 7431).

Disclosure of returns and return information for use in nontax criminal investigations—by ex parte court order

A Federal agency enforcing a nontax criminal law must obtain an *ex parte* court order to receive a return or taxpayer return information (i.e., that information submitted by or on behalf of a taxpayer to the IRS) (section 6103(i)(1)).¹⁹⁹ Only the Attorney General, Deputy Attorney General, Assistant Attorney Generals, United States Attorneys, Independent Counsels, or an attorney in charge of an organized crime strike force may authorize an application for the order.

For a judge or magistrate to grant such an order, the application must demonstrate that:

- There is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed;
- There is reasonable cause to believe that the return or return information is or may be relevant to a matter relating to the commission of such act;
- The return or return information is sought exclusively for use in a Federal criminal investigation or proceeding concerning such act; and
- The information sought reasonably cannot be obtained, under the circumstances, from another source.

Pursuant to the *ex parte* order, the information may be disclosed to officers and employees of the Federal agency who are personally and directly engaged in: (1) the preparation for any judicial or administrative proceeding pertaining to the enforcement of a specifically designated Federal criminal statute (not involving tax administration) to which the United States or such agency is a party, (2) any investigation which may result in such a proceeding, or (3) any Federal grand jury proceeding pertaining to enforcement of such a criminal statute to which the United States or such agency is or may be a party.

¹⁹⁹ Return information other than that submitted by the taxpayer may be obtained by *ex parte* court order under this provision as well.

A Federal agency may obtain, by *ex parte* court order, the return and return information of a fugitive from justice for purposes of locating such individual (section 6103(i)(5)). The application for an *ex parte* order must establish that: (1) a Federal felony arrest warrant has been issued and the taxpayer is a fugitive from justice, (2) the return or return information is sought exclusively for locating the fugitive taxpayer, and (3) reasonable cause exists to believe the information may be relevant in determining the location of the fugitive. Only the Attorney General, Deputy Attorney General, Assistant Attorney Generals, United States Attorneys, Independent Counsels, or an attorney in charge of an organized crime strike force may authorize an application for this order. Once a court grants the application for an *ex parte* order, the return or return information may be disclosed to any Federal agency exclusively for purposes of locating the fugitive individual.

Agency request procedure for disclosure of return information other than taxpayer return information to the IRS for use in criminal investigations

For nontax criminal investigations, Federal agencies can obtain return information, other than taxpayer return information, without a court order. For nontax criminal purposes, the head of a Federal agency and other persons specifically identified by section 6103 may make a written request for return information that was not provided to the IRS by the taxpayer or his representative (section 6103(i)(2)). The written request must contain:

- The taxpayer's name, and address;
- The taxable period for which the information is sought;
- The statutory authority under which the criminal investigation or judicial, administrative or grand jury proceeding is being conducted; and
- The reasons why such disclosure is or may be relevant to the investigation or proceeding. Unlike the requirements for an *ex parte* order, the requesting agency does not have to demonstrate that the information sought is not reasonably available elsewhere.

Disclosure of return information to apprise appropriate officials of criminal activities or emergency circumstances

Criminal activities

Section 6103 permits the IRS to disclose return information (other than taxpayer return information) that may be evidence of a crime (section 6103(i)(3)(A)). The IRS may make the disclosure in writing to the head of a Federal agency charged with enforcing the laws to which the crime relates. Return information also may be disclosed to apprise Federal law enforcement of the imminent flight of any individual from Federal prosecution. The IRS may not disclose returns under this provision.

Emergency circumstances

In cases of imminent danger of death or physical injury to an individual, the IRS may disclose return information to Federal and State law enforcement agencies (section 6103(i)(3)(B)). The statute

does not grant authority, however, to disclose return information to local law enforcement, such as city, county, or town police. The statute does not permit the IRS to disclose return information concerning terrorist activities if there is no imminent danger of death or physical injury to an individual.

Tax convention information

With limited exceptions, the Code prohibits the disclosure of tax convention information (section 6105). A tax convention is any: (1) income tax or gift and estate tax convention, or (2) other convention or bilateral agreement (including multilateral conventions and agreements and any agreement with a possession of the United States) providing for the avoidance of double taxation, the prevention of fiscal evasion, nondiscrimination with respect to taxes, the exchange of tax relevant information with the United States, or mutual assistance in tax matters. Tax convention information is any: (1) agreement entered into with the competent authority of one or more foreign governments pursuant to a tax convention; (2) application for relief under a tax convention; (3) background information related to such agreement or application; (4) document implementing such agreement; and (5) other information exchanged pursuant to a tax convention which is treated as confidential or secret under the tax convention.

The general rule that tax convention information cannot be disclosed does not apply to the disclosure of tax convention information to persons or authorities (including courts and administrative bodies) that are entitled to disclosure under the tax convention and any generally applicable procedural rules regarding applications for relief under a tax convention. It also does not apply to the disclosure of tax convention information not relating to a particular taxpayer if the IRS determines, after consultation with the parties to the tax convention, that such disclosure would not impair tax administration.

Reasons for Change²⁰⁰

For purposes of investigating terrorist activity or threats and analyzing intelligence, the Congress believed it necessary to expand present law disclosure rules.

Explanation of Provision

In general

The Act expands the availability of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. In general, under the Act, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting

²⁰⁰ The legislative history for H.R. 2884 does not include reasons for change. The reasons for change reported here are adapted from the Technical Explanation to the Economic Recovery and Assistance for American Workers Act of 2001 (S. Prt. No. 107-49). The Senate Finance Committee produced this report in connection with H.R. 3090, which contained certain provisions similar to those enacted in Pub. L. No. 107-134.

specific requirements. Prior and present-law safeguards, record-keeping, reporting requirements, and civil and criminal penalties for unauthorized disclosures apply to disclosures made pursuant to the Act. The Act also permits the disclosure of tax convention information for the same purposes and in the same manner that return information is made available under the Act. No disclosures may be made under the Act after December 31, 2003.

Disclosure of returns and return information including taxpayer return information—by ex parte court order

Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies.—The Act permits, pursuant to an *ex parte* court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the *ex parte* court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that:

- There is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and
- The return or return information is sought exclusively for the use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

Special rule for ex parte court ordered disclosure initiated by the IRS.—If the Secretary of Treasury possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary of the Treasury (or his delegate), may on his own initiative, authorize an application for an *ex parte* court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. Under the Act, the information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Depart-

ment of Justice represents the Secretary of the Treasury in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS *ex parte* court order.

Disclosure of return information other than taxpayer return information

Disclosure by the IRS without a request.—The Act permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. As under prior and present law Code section 6103(i)(3)(A), the IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

Disclosure upon written request of a Federal law enforcement agency.—The Act permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Act permits the redisclosure by a Federal law enforcement agency to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or Treasury for intelligence analysis of terrorist activity.—Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information)²⁰¹ to officers and employees of the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is lim-

²⁰¹A taxpayer's identity is treated as not having been supplied by the taxpayer or his representative.

ited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester under the Act.

Tax convention information

The Act permits the disclosure of tax convention information on the same terms as return information may be disclosed under the Act, except that in the case of tax convention information provided by a foreign government, no disclosure may be made under this paragraph without the written consent of the foreign government.

Definitions

The term “terrorist incident, threat, or activity” is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms were defined in the recently enacted USA PATRIOT Act.²⁰²

Effective Date

The provision is effective for disclosures made on or after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

²⁰² 18 U.S.C. 2331.

**IV. NO IMPACT ON SOCIAL SECURITY TRUST FUNDS
(Sec. 301 of the Act)**

Present and Prior Law

Present law provides for the transfer of Social Security taxes and certain self-employment taxes to the Social Security trust fund. In addition, the income tax collected with respect to a portion of Social Security benefits included in gross income is transferred to the Social Security trust fund.

Explanation of Provision

The Act provides that the Secretary is to annually estimate the impact of the Act on the income and balances of the Social Security trust fund. If the Secretary determines that the Act has a negative impact on the income and balances of the fund, then the Secretary is to transfer from the general revenues of the Federal government an amount sufficient so as to ensure that the income and balances of the Social Security trust funds are not reduced as a result of the Act. Such transfers are to be made not less frequently than quarterly.

The Act provides that the provisions of the Act are not to be construed as an amendment of title II of the Social Security Act.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

**PART EIGHT: JOB CREATION AND WORKER ASSISTANCE
ACT OF 2002 (PUBLIC LAW 107-147)²⁰³**

TITLE I. BUSINESS PROVISIONS

**A. Special Depreciation Allowance for Certain Property (sec.
101 of the Act and sec. 168 of the Code)**

Present and Prior Law

Depreciation deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

With respect to passenger automobiles, section 280F limits the annual depreciation deductions to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (section 179). This amount is increased to \$25,000 for taxable years beginning in 2003 and thereafter. 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.

²⁰³H.R. 3090. The bill was reported by the House Committee on Ways and Means on October 17, 2001 (H.R. Rep. No. 107-251). The bill passed the House on October 24, 2001. The bill was reported with an amendment in the nature of a substitute by the Senate Committee on Finance on November 9, 2001 (S. Prt. No. 107-49). Another Finance Committee substitute was proposed and failed on the Senate Floor on November 14, 2001. An amendment in the nature of a substitute passed the Senate by voice vote on February 14, 2002. The House passed the bill with an amendment to the Senate amendment on March 7, 2002. The Senate agreed to the House amendment to the Senate amendment on March 8, 2002. The bill was signed by the President on March 9, 2002.

Reasons for Change

The Congress believes that allowing additional first-year depreciation will accelerate purchases of equipment, promote capital investment, modernization, and growth, and will help to spur an economic recovery.

Explanation of Provision

JCWA allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.²⁰⁴ The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.²⁰⁵ The basis of the property and the depreciation allowances in the placed-in-service year and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, JCWA provides that there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS²⁰⁶ apply (1) with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property.²⁰⁷ Sec-

²⁰⁴ The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

²⁰⁵ The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

²⁰⁶ A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

²⁰⁷ Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) of that portion of the building, or by the lessor of that portion of the building. That portion of the building is to be occupied exclusively by the lessee (or any sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

For these purposes, a binding commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee. A lease between related persons is not considered a lease for this purpose.

Finally, New York Liberty Zone qualified leasehold improvement property, as described in new Code sec. 1400L(b), is not eligible for the additional first year depreciation deduction.

²⁰⁸ The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. It is intended that, when evaluating whether property qualifies as "original use," the factors used to determine whether property qualified as "new section 38 property" for purposes of the investment tax credit would apply. See Treasury Regulation 1.48-2. Thus, it is intended that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement. For example, assume on February 1, 2002, a taxpayer buys from X for \$20,000 a machine that has been previously used by X. Prior to September 11, 2004, the taxpayer makes an expenditure on the property of \$5,000 of the type that must be capitalized. Regardless of whether the \$5,000 is added to the basis of such property or is capitalized as a separate asset, such amount would be treated as satisfying the "original

ond, the original use²⁰⁸ of the property must commence with the taxpayer on or after September 11, 2001.²⁰⁹ Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the placed in service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.²¹⁰ Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is: (1) after September 10, 2001 and before September 11, 2004, and no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004.²¹¹ With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 (“progress expenditures”) are eligible for the additional first year depreciation.²¹²

Congress intended that property not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner.²¹³ For example, if a taxpayer sells to a related party property that was under construction prior to Sep-

use” requirement and would be qualified property (assuming all other conditions are met). No part of the \$20,000 purchase price would qualify for the additional first year depreciation.

In addition, Congress intended that if in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, that the original use of such property begins with the first user of each fractional interest (i.e., each first fractional owner is considered the original user of its proportionate share of the property).

²⁰⁹A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

Congress intended that if property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(ii)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the purchaser not earlier than the date of such sale. A technical correction may be needed so that the statute reflects this intent.

²¹⁰In order for property to qualify for the extended placed in service date, the property is required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding \$1 million.

²¹¹Congress did not intend to preclude property from qualifying for the additional first year depreciation merely because a binding written contract to acquire a component of the property was in effect prior to September 11, 2001.

²¹²For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

²¹³A technical correction may be needed so that the statute reflects this intent.

tember 11, 2001, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer sells property and leases the property back in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (section 280F of the Code) is increased in the first year by \$4,600 for automobiles that qualify (and do not elect out of the increased first year deduction). The \$4,600 increase is not indexed for inflation.

The following examples illustrate the operation of the provision.

EXAMPLE 1.—Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs \$1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of \$300,000. The remaining \$700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2.—Assume that during 2002, a calendar year taxpayer acquires and places in service qualified property that costs \$50,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a \$24,000 deduction under section 179. The taxpayer then is allowed an additional first-year depreciation deduction of \$7,800 based on \$26,000 (\$50,000 original cost less the section 179 deduction of \$24,000) of adjusted basis. Finally, the remaining adjusted basis of \$18,200 (\$26,000 adjusted basis less \$7,800 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

Effective Date

The provision applies to property placed in service after September 10, 2001.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$35,329 million in 2002, \$32,378 million in 2003, \$29,178 million in 2004, and increase Federal fiscal year budget receipts by \$136 million in 2005, \$18,951 million in 2006, \$18,265 million in 2007, \$15,354 million in 2008, \$11,638 million in 2009, \$8,023 million in 2010, \$5,328 million in 2011, and \$3,372 million in 2012.

B. Five-Year Carryback of Net Operating Losses (sec. 102 of the Act and secs. 172 and 56 of the Code)

Present and Prior Law

A net operating loss (“NOL”) is, generally, the amount by which a taxpayer’s allowable deductions exceed the taxpayer’s gross in-

come. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryover of an NOL reduces Federal income tax for the carryover year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years. Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs: (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI.

Reasons for Change

The NOL carryback and carryover rules are designed to allow taxpayers to smooth out swings in business income (and Federal income taxes thereon) that result from business cycle fluctuations and unexpected financial losses. The uncertain economic conditions have resulted in many taxpayers incurring unexpected financial losses. A temporary extension of the NOL carryback period provides taxpayers in all sectors of the economy who experience such losses the ability to increase their cash flow through the refund of income taxes paid in prior years, which can be used for capital investment or other expenses that will provide stimulus to the economy.

Explanation of Provision

JCWA temporarily extends the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002.²¹⁴ In addition, the five-year carryback period applies to NOLs from these years that otherwise qualify for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

²¹⁴JCWA does not affect the terms and conditions that the Internal Revenue Service may impose on a taxpayer seeking approval for a change in its annual accounting period. *See e.g.*, Rev. Proc. 2000-11, 2000-1 C.B. 309, sec. 5.06 ("If the corporation (or consolidated group) has a NOL (or consolidated NOL) in the short period required to effect the change, the NOL may not be carried back but must be carried over in accordance with the provisions of sec. 172 beginning with the first taxable year after the short period. However, the short period NOL (or consolidated NOL) is carried back or carried over in accordance with sec. 172 if it is either: (a) \$50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL (or the consolidated NOL) for a full 12-month period beginning with the first day of the short period.")

The IRS, however, may alter or modify such terms and conditions where modification is sought by taxpayers (including taxpayers that had already received permission to change accounting periods) as it deems appropriate or necessary to further the purposes of this provision. *See* 148 Cong. Rec. S1702 (daily ed. March 8, 2002) (colloquy between Senators Hatch and Baucus).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.²¹⁵

JCWA also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryovers to these taxable years, to offset 100 percent of a taxpayer's AMTI.²¹⁶

Effective Date

The 5-year carryback provision is effective for net operating losses generated in taxable years ending after December 31, 2000.

The provision allowing the use of NOL carrybacks and carryovers to offset 100 percent of AMTI is effective for taxable years beginning before January 1, 2003.²¹⁷

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$7,927 million in 2002, \$6,623 million in 2003, and increase Federal fiscal year budget receipts by \$4,197 million in 2004, \$2,865 million in 2005, \$1,891 million in 2006, \$1,256 million in 2007, \$840 million in 2008, \$568 million in 2009, \$388 million in 2010, \$269 million in 2011, and \$191 million in 2012.

²¹⁵ Because JCWA was enacted after some taxpayers had filed returns for years affected by the provision, a technical correction is needed to provide for a period of time in which prior decisions regarding the NOL carryback may be reviewed. Similarly, a technical correction is needed to modify the carryback adjustment procedures of sec. 6411 for NOLs arising in 2001 and 2002. These issues were addressed in a letter dated April 15, 2002, sent by the Chairman and Ranking Member of the House Ways and Means Committee and Senate Finance Committee, as well as in guidance issued by the IRS pursuant to the Congressional letter (Rev. Proc. 2002-40, 2002-23 I.R.B. 1096, June 10, 2002). See section 2(b) of H.R. 5713 and S. 3153, the Tax Technical Corrections Act of 2002.

²¹⁶ Section 172(b)(2) should be appropriately applied in computing AMTI to take proper account of the order that the NOL carryovers and carrybacks are used as a result of this provision. See section 56(d)(1)(B)(ii).

²¹⁷ A technical correction may be needed in connection with the date. See section 2(b)(3) of H.R. 5713 and S. 3153, the Tax Technical Corrections Act of 2002.

**TITLE II. TAX BENEFITS FOR AREA OF NEW YORK CITY
DAMAGED IN TERRORIST ATTACKS ON SEPTEMBER
11, 2001**²¹⁸

A. Expansion of Work Opportunity Tax Credit Targeted Categories to Include Certain Employees in New York City (sec. 301 of the Act and new sec. 1400L(a) of the Code)

Present and Prior Law

In general

The work opportunity tax credit (“WOTC”) is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (“TANF”) Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (“SSI”) benefits.

The employer’s deduction for wages is reduced by the amount of the credit.

²¹⁸The interaction of the tax benefits for New York City in the JCWA with the business tax provisions of Title I JCWA has revenue effects which are not reflected in the revenue effects provided in the individual provisions of JCWA. The revenue effects of such interaction are as follows: The interaction of the provisions increase Federal fiscal year budget receipts of \$563 million in 2002, \$520 million in 2003, and \$470 million in 2004, and reduce Federal year fiscal budget receipts by \$42 million in 2005, \$303 million in 2006, \$270 million in 2007, \$228 million in 2008, \$173 million in 2009, \$120 million in 2010, \$80 million in 2011, and \$52 million in 2012.

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2004.²¹⁹

Explanation of Provision

JCWA creates a new targeted group for the WOTC. Generally, the new targeted group is individuals who perform substantially all their services in the recovery zone for a business located on or south of Canal street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, New York (the “New York Liberty Zone”). The new targeted group also includes individuals who perform substantially all their services in New York City for a business that relocated from the New York Liberty Zone elsewhere within New York City due to the physical destruction or damage of their workplaces within the New York Liberty Zone by the September 11, 2001 terrorist attack. It is anticipated that only otherwise qualified businesses that relocate due to significant physical damage will be eligible for the credit.

Generally qualified wages for purposes of this targeted group are wages paid or incurred for work performed in the New York Liberty Zone after December 31, 2001 and before January 1, 2004 by such qualified individuals. Also, in the case of otherwise qualified businesses that relocated due to the destruction or damage of their workplaces by the September 11, 2001 terrorist attack, the credit can be claimed for work performed outside of the zone but within New York City subject to the dates specified above. Other rules like the minimum employment periods (section 51(i)(3)) of the WOTC apply.

Unlike the other targeted categories, the credit for the new targeted group is available for wages paid to both new hires and existing employees. For each qualified business that relocated from the New York Liberty Zone elsewhere within New York City due to the physical destruction or damage of their workplaces within the New York Liberty Zone, the number of that employer’s employees whose wages are eligible under the new targeted category may not exceed the number of its employees in the New York Liberty Zone on September 11, 2001. Other qualified businesses (e.g., businesses that operate in the New York Liberty Zone both on and after Sept. 11, 2001 and businesses that move into the New York Liberty Zone after September 11, 2001) would not be subject to that limitation.

No credit for this new category of workers is allowed if the otherwise qualifying employer on average employed more than 200 employees during the taxable year in question.

Unlike the other targeted categories, members of this targeted group will not require certification for their wages to qualify for the credit.

²¹⁹ Section 604 of JCWA, also described in Part Eight of this document, provides for the extension of the WOTC for two years (for wages paid to qualified individuals who began work for an employer after December 31, 2001 and before January 1, 2004).

For the new category, the maximum credit is \$2,400 (40 percent of \$6,000 of qualified wages) per qualified employee in each taxable year.

The portion of each employer's WOTC credit attributable to the new targeted group is allowed against the alternative minimum tax.

Effective Date

The provision is effective in taxable years ending after December 31, 2001 (for wages paid or incurred to qualified individuals for work after December 31, 2001 and before January 1, 2004).

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$119 million in 2002, \$259 million in 2003, \$176 million in 2004, \$52 million in 2005, \$19 million in 2006, and \$6 million in 2007.

B. Special Depreciation Allowance for Certain Property (sec. 301 of the Act and new sec. 1400L(b) of the Code)

Present and Prior Law

Depreciation deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under MACRS. The MACRS system assigns different applicable recovery periods and depreciation methods to different types of property. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized. In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (section 179). For taxable years beginning in 2003 and thereafter, the amount deductible under section 179 is increased to \$25,000.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

Explanation of Provision

JCWA allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified New York Lib-

erty Zone property.²²⁰ The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.²²¹ The basis of the property and the depreciation allowances in the placed-in-service year and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS²²² apply (1) with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified New York Liberty Zone leasehold improvement property²²³ and, (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first year depreciation). Second, substantially all of the use of such property must be in the New York Liberty Zone. Third, the original use²²⁴ of the property in the New York Liberty Zone must commence with the taxpayer on or after September 11, 2001.²²⁵ Finally, the property must be acquired by purchase²²⁶ by the taxpayer (1) after September 10, 2001, and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009, in lieu of December 31, 2006. Property will not qualify if a binding written contract for the

²²⁰ The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

²²¹ The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

²²² A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

²²³ Qualified New York Liberty Zone leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as "qualified New York Liberty Zone leasehold improvement property" maybe eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

²²⁴ Thus, used property may constitute qualified property so long as it has not previously been used within the Liberty Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Liberty Zone began with the taxpayer would satisfy the "original use" requirement. See Treasury Regulation 1.48-2 Example 5.

²²⁵ A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property will be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

It is the intent of Congress that if property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(ii)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the purchaser not earlier than the date of such sale. A technical correction may be needed so that the statute reflects this intent.

²²⁶ For purposes of this provision, purchase is defined under section 179(d).

acquisition of such property was in effect before September 11, 2001.²²⁷

Nonresidential real property and residential rental property is eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Property shall be treated as replacing destroyed property, if as part of an integrated plan, such property replaces real property which is included in a continuous area which includes real property destroyed or condemned. For purposes of this provision, it is intended that real property destroyed (or condemned) only include circumstances in which an entire building or structure was destroyed (or condemned) as a result of the terrorist attacks. Otherwise, such property is considered damaged real property. For example, if certain structural components (e.g., walls, floors, or plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks but the building is not destroyed (or condemned), then only costs related to replacing the damaged or destroyed components qualifies for the provision.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006²²⁸ (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Congress intended that property not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner.²²⁹

The following examples illustrate the operation of the provision.

EXAMPLE 1.—Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property in the New York Liberty Zone that costs \$1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of \$300,000. The remaining \$700,000 of adjusted basis is recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2.—Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property in the New York Liberty Zone that costs \$100,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a \$59,000

²²⁷ Congress did not intend to preclude property from qualifying for the additional first year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

²²⁸ December 31, 2009, with respect to qualified nonresidential real property and residential rental property.

²²⁹ A technical correction may be needed so that the statute reflects this intent.

deduction under section 179.²³⁰ The taxpayer then is allowed an additional first-year depreciation deduction of \$12,300 based on \$41,000 (\$100,000 original cost less the section 179 deduction of \$59,000) of adjusted basis. Finally, the remaining adjusted basis of \$28,700 (\$41,000 adjusted basis less \$12,300 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

Revenue Effect

The provisions are expected to decrease Federal fiscal year budget receipts by \$622 million in 2002, \$604 million in 2003, \$600 million in 2004, \$597 million in 2005, \$565 million in 2006, and increase Federal fiscal year budget receipts by \$42 million in 2007, \$335 million in 2008, \$261 million in 2009, \$312 million in 2010, \$273 million in 2011, and \$199 million in 2012.

C. Treatment of Qualified Leasehold Improvement Property (sec. 301 of the Act and new sec. 1400L of the Code)

Present Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under MACRS of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period is longer than the term of the lease (section 168(i)(8)).²³¹ This rule applies regardless of who places the leasehold improvements in service.²³² If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).²³³

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrev-

²³⁰ Section 301 of JCWA provides that property in the Liberty Zone is eligible for an additional \$35,000 of expensing under section 179.

²³¹ The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

²³² Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

²³³ If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

ocably disposed of or abandoned by the lessor at the termination of the lease.²³⁴ This rule conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of a lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.²³⁵

Explanation of Provision

JCWA provides that for purposes of the depreciation rules of section 168 5-year property includes qualified New York Liberty Zone leasehold improvement property (“qualified NYLZ leasehold improvement property”). The term qualified NYLZ leasehold improvement property means property defined in section 168(k)²³⁶ that is acquired and placed in service after September 10, 2001 and before January 1, 2007 (and not subject to a binding contract on September 10, 2001) in the New York Liberty Zone. The straight-line method is required to be used with respect to qualified NYLZ leasehold improvement property. A nine-year period is specified as the class life of qualified NYLZ leasehold improvement property for purposes of the alternative depreciation system.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$11 million in 2002, \$26 million in 2003, \$45 million in 2004, \$70 million in 2005, \$102 million in 2006, \$115 million in 2007, \$101 million in 2008, \$79 million in 2009, \$50 million in 2010, \$12 million in 2011, and increase Federal fiscal year budget receipts by \$14 million in 2012.

D. Authorize Issuance of Tax-Exempt Private Activity Bonds for Rebuilding the Portion of New York City Damaged in the September 11, 2001, Terrorist Attack (sec. 301 of the Act and new sec. 1400L(d) of the Code)

Present and Prior Law

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (section 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private per-

²³⁴ The conference report to the Small Business Job Protection Act of 1996 (H. Rept. 104-737) describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

²³⁵ Under present and prior law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

²³⁶ Section 168(k) regarding qualified leasehold improvement property is added by section 101 of JCWA.

son is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called “private activity bonds.” The term “private person” includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present and prior law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt bonds (“qualified 501(c)(3) bonds”).

States or local governments may issue tax-exempt “exempt-facility bonds” to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately owned and/or operated low-income rental housing;²³⁷ and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for “environmental enhancements of hydro-electric generating facilities.” Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers (“qualified small-issue bonds”), local redevelopment activities (“qualified redevelopment bonds”), and eligible empowerment zone and enterprise community businesses.

Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing (“qualified mortgage bonds” and “qualified veterans” mortgage bonds”). Purchasers of houses financed with qualified mortgage bonds must be first-time homebuyers satisfying prescribed income limits, the purchase prices of the houses is limited, the amount by which interest rates charged to homebuyers may exceed the interest paid by issuers is restricted, and a recapture provision applies to target the benefit to purchasers having longer-term need for the subsidy provided by the bonds. Qualified veterans’ mortgage bonds generally are not subject to these limitations, but these bonds may only be issued by five States and may only be used to finance mortgage loans to veterans who served on active duty before January 1, 1977.

With the exception of qualified 501(c)(3) bonds, private activity bonds may not be issued to finance working capital requirements of private businesses.

In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits. For calendar year 2002, these annual volume limits were equal to the greater of \$75 per resident of the State or \$225

²³⁷ Residential rental projects must satisfy low-income tenant occupancy requirements for a minimum period of 15 years.

million. After 2002, the volume limits will be indexed annually for inflation.

Arbitrage restrictions on tax-exempt bonds

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

Miscellaneous additional restrictions on tax-exempt bonds

Several additional restrictions apply to the issuance of tax-exempt bonds. First, private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds are not retired within 90 days of issuance of the refunding bonds.

Issuance of private activity bonds is subject to restrictions on use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores) and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Additionally, the term of the bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds. Present and prior law precludes substantial users of property financed with private activity bonds from owning the bonds to prevent their deducting tax-exempt interest paid to themselves. Finally, owners of most private-activity-bond-financed property are subject to special “change-in-use” penalties if the use of the bond-financed property changes to a use that is not eligible for tax-exempt financing while the bonds are outstanding.

Explanation of Provision

JCWA authorizes issuance during calendar years 2002, 2003, and 2004 of an aggregate amount of \$8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of non-

residential real property²³⁸ and residential rental real property²³⁹ in a newly designated “Liberty Zone” (the “Zone”) of New York City.²⁴⁰ Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,²⁴¹ and public utility property (e.g., gas, water, electric and telecommunication lines). All business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan are considered to be located within the Zone. Issuance of bonds authorized under JCWA is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to \$4 billion of the bonds authorized under the Act.

If the Mayor or the Governor determines that it is not feasible to use all of the authorized bonds that he is authorized to designate for property located in the Zone, up to \$1 billion of bonds may be designated by each to be used for the acquisition, construction, and rehabilitation of nonresidential real property (including fixed tenant improvements) located outside the Zone and within New York City.²⁴² Bond-financed property located outside the Zone must meet the additional requirement that the project have at least 100,000 square feet of usable office or other commercial space in a single building or multiple adjacent buildings.

Subject to the following exceptions and modifications, issuance of these tax-exempt bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

- (1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (section 146);
- (2) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost of acquiring the building being devoted to rehabilitation (section 147(d));
- (3) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of the bonds (section 148(f)(4)(C));
- (4) The tenant targeting rules applicable to exempt-facility bonds for residential rental property (and the corresponding change in use penalties for violations of those rules) do not

²³⁸ No more than \$800 million of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The term nonresidential real property includes structural components of such property if the taxpayer treats such components as part of the real property structure for all Federal income tax purposes (e.g., cost recovery). The \$800 million limit is divided equally between the Mayor and the Governor.

²³⁹ No more than \$1.6 billion of the authorized bond amount may be used to finance residential rental property. The \$1.6 billion limit is divided equally between the Mayor and the Governor.

²⁴⁰ Current refundings of outstanding bonds issued under JCWA do not count against the \$8 billion volume limit to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the bonds being refunded. In addition, qualified New York Liberty Bonds may be issued after December 31, 2004 to refund (other than advance refund) qualified New York Liberty Bonds originally issued before January 1, 2005, to the extent the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. The bonds may not be advance refunded.

²⁴¹ Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.

²⁴² Public utility property and residential property located outside the Zone cannot be financed with the bonds.

apply to such property financed with the bonds (secs. 142(d) and 150(b)(2));

(5) Repayments of bond-financed loans may not be used to make additional loans, but rather must be used to retire outstanding bonds (with the first such retirement occurring 10 years after issuance of the bonds);²⁴³ and

(6) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (section 57(a)(5)).

Effective Date

The provision is effective for bonds issued after the date of enactment and before January 1, 2005.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$11 million in 2002, \$41 million in 2003, \$90 million in 2004, \$127 million in 2005, and \$137 million annually in 2006 through 2012.

E. Allow One Additional Advance Refunding for Certain Previously Refunded Bonds for Facilities Located in New York City (sec. 301 of the Act and sec. 1400L(d) of the Code)

Present and Prior Law

Interest on bonds issued by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (section 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called private activity bonds. Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. One such exception is the provision of financing for activities of charitable organizations described in section 501(c)(3) of the Code (“qualified 501(c)(3) bonds”).

A refunding bond is used to redeem a prior bond issuance. The Code contains different rules for “current” as opposed to “advance” refunding bonds. Tax-exempt bonds may be refunded currently an indefinite number of times. A current refunding occurs when the refunded debt is redeemed within 90 days of issuance of the refunding bonds. Governmental bonds and qualified 501(c)(3) bonds

²⁴³It is intended that redemptions will occur at least semi-annually beginning at the end of 10 years after the bonds are issued; however amounts less than \$250,000 are not required to be used to redeem bonds at such intervals.

also may be advance refunded one time (section 149(d)).²⁴⁴ An advance refunding occurs when the refunded debt is not redeemed within 90 days after the refunding bonds are issued. Rather, proceeds of the refunding bonds are invested in an escrow account and held until a future date when the refunded debt may be redeemed under the terms of the refunded bonds.

Explanation of Provision

JCWA permits certain bonds for facilities located in New York City to be advance refunded one additional time. These bonds include only bonds for which all present-law advance refunding authority was exhausted before September 12, 2001, and with respect to which the advance refunding bonds authorized under present law were outstanding on September 11, 2001.²⁴⁵ Further, to be eligible for the additional advance refunding, at least 90 percent²⁴⁶ of the net proceeds of the refunded bonds must have been used to finance facilities located in New York City,²⁴⁷ and the bonds must be—

- (1) Governmental general obligation bonds of New York City;
- (2) Governmental bonds issued by the Metropolitan Transportation Authority of the State of New York;²⁴⁸
- (3) Governmental bonds issued by the New York Municipal Water Finance Authority;²⁴⁹ or
- (4) Qualified 501(c)(3) bonds issued by or on behalf of New York State or New York City to finance hospital facilities (within the meaning of section 145(c)).

The maximum amount of advance refunding bonds that may be issued pursuant to this provision is \$9 billion. Eligible advance refunding bonds must be designated as such by the Mayor of New York City or the Governor of New York State. Up to \$4.5 billion of bonds may be designated by each of these officials. Advance refunding bonds issued under the provision must satisfy all requirements of section 148 and 149(d) except for the limit on the number of advance refundings allowed under section 149(d).

Effective Date

The provision is effective on the date of enactment and before January 1, 2005.

²⁴⁴ Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

²⁴⁵ At no time after the advance refunding authorized under the provision occurs may there be more than two sets of bonds outstanding.

²⁴⁶ This requirement is 95 percent in the case of eligible qualified 501(c)(3) bonds.

²⁴⁷ In the case of bonds for water facilities issued by the New York Municipal Water Finance Authority, property located outside New York City that is functionally related and subordinate to property located in the city is deemed to be located in the city.

²⁴⁸ Bonds issued by the New York City Transit Authority or the Triborough Bridge and Tunnel Authority that otherwise satisfy the requirements of this provision are treated as issued by the Metropolitan Transportation Authority of the State of New York. See, Internal Revenue Service, Notice 2002-42, *New York Liberty Zone Questions and Answers* (June 24, 2002).

²⁴⁹ The reference to the “New York Municipal Water Finance Authority” is deemed to refer to the New York City Municipal Water Finance Authority. See, Internal Revenue Service, Notice 2002-42, *New York Liberty Zone Questions and Answers* (June 24, 2002).

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$103 million in 2002, \$124 million in 2003, \$133 million in 2004, \$125 million in 2005, \$115 million in 2006, \$98 million in 2007, \$80 million in 2008, \$64 million in 2009, \$49 million in 2010, \$30 million in 2011, and \$15 million in 2012.

F. Increase in Expensing Treatment for Business Property Used in the New York Liberty Zone (sec. 301 of the Act and new sec. 1400L of the Code)

Present and Prior Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (section 179). This amount is increased to \$25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. The amount is phased-out (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

Additional section 179 incentives are provided with respect to a qualified zone property used by a business in an empowerment zone (section 1397A). Such a business may elect to deduct an additional \$20,000 of the cost of qualified zone property placed in service in year 2001. The \$20,000 amount is increased to \$35,000 for taxable years beginning in 2002 and thereafter. In addition, the phase-out range is applied by taking into account only 50 percent of the cost of qualified zone property that is section 179 property.

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

Explanation of Provision

JCWA increases the amount a taxpayer can deduct under section 179 for qualifying property used in the New York Liberty Zone.²⁵⁰ Specifically, JCWA increases the maximum dollar amount that may be deducted under section 179 by the lesser of: (1) \$35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

²⁵⁰The "New York Liberty Zone" means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

Qualifying property²⁵¹ means section 179 property²⁵² purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where: (1) substantially all of its use is in the New York Liberty Zone in the active conduct of a trade or business by the taxpayer in the zone, and (2) the original use of which in the New York Liberty Zone commences with the taxpayer after September 10, 2001.²⁵³

As under present and prior law with respect to empowerment zones, the phase-out range for the section 179 deduction attributable to New York Liberty Zone property is applied by taking into account only 50 percent of the cost of New York Liberty Zone property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Effective Date

The provision is effective for property placed in service after September 10, 2001 and before January 1, 2007.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$36 million in 2002, \$56 million in 2003, \$37 million in 2004, \$29 million in 2005, \$23 million in 2006, and increase Federal fiscal year budget receipts by \$20 million in 2007, \$49 million in 2008, \$31 million in 2009, \$21 million in 2010, \$14 million in 2011, and \$9 million in 2012.

G. Extension of Replacement Period for Certain Property Involuntarily Converted in the New York Liberty Zone (sec. 301 of the Act and new sec. 1400L of the Code)

Present and Law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the “replacement period”) property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In

²⁵¹ As drafted, if property qualifies for both the general additional first-year depreciation and Liberty Zone additional first-year depreciation, it is deemed to be eligible for the general additional first-year depreciation and is not considered New York Liberty Zone property (i.e., only one 30-percent additional first-year depreciation deduction is allowed). Because only New York Liberty Zone property is eligible for the increased section 179 expensing amount, the legislation has the unintended consequence of denying the increased section 179 expensing to New York Liberty Zone property. This issue was addressed in a letter dated April 15, 2002, sent by the Chairman and Ranking Member of the House Ways and Means Committee and Senate Finance Committee. The Tax Technical Corrections Act of 2002, introduced on November 13, 2002 (H.R. 5713 in the House of Representatives and S. 3153 in the Senate), includes a provision that corrects this unintended result (such that qualifying Liberty Zone property qualifies for both the 30-percent additional first-year depreciation and the additional section 179 expensing).

²⁵² As defined in section 179(d)(1).

²⁵³ Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (May 20, 2002), described procedures on claiming the increased section 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.²⁵⁴ The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.²⁵⁵

Special rules apply for property converted in a Presidentially declared disaster.²⁵⁶ With respect to a principal residence that is converted in a Presidentially declared disaster, no gain is recognized by reason of the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. In addition, the replacement period for the replacement of such a principal residence is extended to four years after the close of the first taxable year in which any part of the gain upon conversion is realized. With respect to investment or business property that is converted in a Presidentially declared disaster, any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to the converted property.

Explanation of Provision

JCWA extends the replacement period to five years for a taxpayer to purchase property to replace property that was involuntarily converted within the New York Liberty Zone²⁵⁷ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

Effective Date

The provision is effective for involuntary conversions in the New York Liberty Zone occurring on or after September 11, 2001, as a consequence of the terrorist attacks on such date.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$145 million in 2002, \$199 million in 2003, \$18 million in 2004, and increase Federal fiscal year budget receipts by \$1 million in 2005, \$2 million in 2006, \$3 million in 2007, \$6 million in 2008, \$7 million in 2009 and 2010, \$8 million in 2011, and \$9 million in 2012.

²⁵⁴ Section 1033(a)(2)(B).

²⁵⁵ Section 1033(g)(4).

²⁵⁶ Section 1033(h). For this purpose, a "Presidentially declared disaster" means any disaster which, with respect to the area in which the property is located, resulted in a subsequent determination by the President that such area warrants assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act.

²⁵⁷ The "New York Liberty Zone" has the same definition throughout the JCWA.

TITLE III. MISCELLANEOUS AND TECHNICAL PROVISIONS

Subtitle A—General Miscellaneous Provisions

A. Allowance of Electronic Forms 1099 (sec. 401 the Act)

Present and Prior Law

Temporary regulations allow Form W-2 to be furnished electronically on a voluntary basis. Under temporary Treasury regulations,²⁵⁸ a recipient must have affirmatively consented to receive the statement electronically and must not have withdrawn that consent before the statement is furnished.

Reasons for Change

Recent stresses have been placed on the United States Postal Service, the IRS, and taxpayers as a result of terrorist activities. The Congress believed that one step to be taken in relieving such stress is to reduce the amount of mail being sent to taxpayers who desire to receive information electronically.

Explanation of Provision

JCWA allows IRS Form 1099 to be provided to taxpayers electronically, if they so consented.

Effective Date

The provision is effective on date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

B. Discharge of Indebtedness of an S Corporation (sec. 402 of the Act and sec. 108 of the Code)

Present and Prior Law

In general, an S corporation is not subject to the corporate income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on their individual income tax returns. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the

²⁵⁸Temp. Treas. Reg. sec. 31.6051-1T(j).

amount of any losses (including nondeductible losses) taken into account. A shareholder may deduct losses only to the extent of a shareholder's basis in his or her stock in the S corporation plus the shareholder's adjusted basis in any indebtedness of the corporation to the shareholder. Any loss that is disallowed by reason of lack of basis is "suspended" at the corporate level and is carried forward and allowed in any subsequent year in which the shareholder has adequate basis in the stock or debt.

In general, gross income includes income from the discharge of indebtedness. However, income from the discharge of indebtedness of a taxpayer in a bankruptcy case or when the taxpayer is insolvent (to the extent of the insolvency) is excluded from income.²⁵⁹ The taxpayer is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income.

In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness by a creditor of the S corporation is excluded from the corporation's income, and the S corporation reduces its tax attributes (including any suspended losses).

To illustrate these rules, assume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows \$100 from a third party and loses the entire \$100. Because the shareholder has no basis in its stock, the \$100 loss is "suspended" at the corporate level. If the \$100 debt is forgiven when the corporation is in bankruptcy or is insolvent, the \$100 income from the discharge of indebtedness is excluded from income, and the \$100 "suspended" loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.

Notwithstanding the economics of the overall transaction, the United States Supreme Court ruled in the case of *Gitlitz v. Commissioner*²⁶⁰ that, under prior law, income from the discharge of indebtedness of an S corporation that was excluded from income was treated as an item of income which increased the basis of a shareholder's stock in the S corporation and allowed the suspended corporate loss to pass through to a shareholder. Thus, under the decision, an S corporation shareholder was allowed to deduct a loss for tax purposes that it did not economically incur.

Reasons for Change

The Congress believed that it was inappropriate for a shareholder of an insolvent or bankrupt S corporation to take into account excluded income from the discharge of the S corporation's indebtedness and thereby increase the shareholder's adjusted basis in the stock. Under the provisions of the Code, an increase in the

²⁵⁹ Section 108. Special rules also apply to certain real estate debt and farm debt.

²⁶⁰ 531 U.S. 206 (2001).

stock basis allowed the shareholder a deduction for an amount of loss that was not economically borne by the shareholder.

As a general matter, the Congress believes that where, as in the case of the prior statute under section 108, the plain text of a provision of the Internal Revenue Code produces an ambiguity, the provision should be read as closing, not maintaining, a loophole that would result in an inappropriate reduction of tax liability.

Explanation of Provision

JCWA provides that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation.

Effective Date

The provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

Revenue Effect

The provision is expected to increase Federal fiscal year budget receipts by \$34 million in 2002, \$76 million in 2003, \$86 million in 2004, \$88 million in 2005, \$91 million in 2006, \$94 million in 2007, \$97 million in 2008, \$99 million in 2009, \$102 million in 2010, \$106 million in 2011, and \$109 million in 2012.

C. Limitation on Use of Non-Accrual Experience Method of Accounting (sec. 403 of the Act and sec. 448 of the Code)

Present and Prior Law

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Generally, a cash method taxpayer is not required to include an amount in income until received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed \$5 million. An exception to this \$5

million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed \$5 million.

Reasons for Change

The Congress understood that the use of the non-accrual experience method provides the equivalent of a bad debt reserve, which generally is not available to taxpayers using an accrual method of accounting. The Congress believed that accrual method taxpayers should be treated similarly, unless there is a strong indication that different treatment is necessary to clearly reflect income or to address a particular competitive situation.

The Congress understood that accrual basis providers of qualified services (services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) compete on a regular basis with competitors using the cash method of accounting. The Congress believed that this competitive situation justifies the continued availability of the non-accrual experience method with respect to amounts due to be received for the performance of qualified services. The Congress believed that it is important to avoid the disparity of treatment between competing cash and accrual method providers of qualified services that could result if the non-accrual experience method were eliminated with regard to amounts to be received for such services.

The Congress also recognized the burdens placed on small businesses to comply with the complexity of the federal income tax code and, in this time of economic uncertainty, the importance of cash flow to small businesses. The Congress believed that small business service providers using an accrual method of accounting should be permitted to continue to use the non-accrual experience method.

In addition, the Congress believed that the formula contained in Temporary Treasury regulations²⁶¹ may not clearly reflect the amount of income that, based on experience, would not be collected for many qualified service providers, especially for those where significant time elapses between the rendering of the service and a final determination that the account will not be collected. Providers of qualified services should not be subject to a formula that requires the payments of taxes on receivables that will not be collected.

Explanation of Provision

Under JCWA, the non-accrual experience method of accounting is available only for amounts to be received for the performance of

²⁶¹Temp. Treas. Reg. sec. 1.448-2T.

qualified services and for services provided by certain small businesses. Amounts to be received for all other services are subject to the general rule regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present and prior law, the availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Under a special rule, the non-accrual experience method of accounting continues to be available for the performance of non-qualified services if the average annual gross receipts (as defined in section 448(c)) of the taxpayer (or any predecessor) does not exceed \$5 million. The rules of paragraph (2) and (3) of section 448(c) (i.e., the rules regarding the aggregation of related taxpayers, taxpayers not in existence for the entire three year period, short taxable years, definition of gross receipts, and treatment of predecessors) apply for purposes of determining the average annual gross receipts test.

JCWA requires that the Secretary of the Treasury prescribe regulations to permit a taxpayer to use alternative computations or formulas if such alternative computations or formulas accurately reflect, based on experience, the amount of its year-end receivables that will not be collected. It is anticipated that the Secretary of the Treasury will consider providing safe harbors in such regulations that may be relied upon by taxpayers. In addition, JCWA also provides that the Secretary of the Treasury permit taxpayers to adopt, or request consent of the Secretary of the Treasury to change to, an alternative computation or formula that clearly reflects the taxpayer's experience. JCWA requires the Secretary of Treasury to approve a request provided that the alternative computation or formula clearly reflects the taxpayer's experience.

Effective Date

The provision is effective for taxable years ending after date of enactment. Any change in the taxpayer's method of accounting required as a result of the limitation on the use of the non-accrual experience method is treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any resultant section 481(a) adjustment is to be taken into account over a period not to exceed the lesser of the number of years the taxpayer has used the non-accrual experience method of accounting or four years under principles consistent with those in Revenue Procedure 99-49.²⁶²

Revenue Effect

The provision is expected to increase Federal fiscal year budget receipts by \$5 million in 2002, \$56 million in 2003, \$47 million in 2004, \$29 million in 2005, \$16 million in 2006, \$8 million in 2007, \$10 million in 2008, \$12 million in 2009, \$13 million in 2010, \$15 million in 2011, \$17 million in 2012.

²⁶² 1999-2 C.B. 725.

D. Expansion of the Exclusion from Income for Qualified Foster Care Payments (sec. 404 of the Act and sec. 131 of the Code)

Present and Prior Law

If certain requirements are satisfied, an exclusion from gross income is provided for qualified foster care payments paid to a foster care provider by either (1) a State or local government; or (2) a tax-exempt placement agency. Qualified foster care payments are amounts paid for caring for a qualified foster care individual in the foster care provider's home and difficulty of care payments.²⁶³ A qualified foster care individual is an individual living in a foster care family home in which the individual was placed by: (1) an agency of the State or local government (regardless of the individual's age at the time of placement); or (2) a tax-exempt placement agency licensed by the State or local government (if such individual was under the age of 19 at the time of placement).

Reasons for Change²⁶⁴

The Congress was aware that States, in their continuing efforts to improve the foster care system, have realized the utility of both tax-exempt and for-profit private placement agencies. In some instances, the States have utilized for-profit private placement agencies to perform the functions previously reserved for State or local government or tax-exempt entities. JCWA was intended to modernize the exclusion to reflect these changes at the State level by equalizing the tax treatment of payments to qualified foster care providers regardless of the source of the payment. Also, the Congress believed that allowing placement by any qualified foster care agency (regardless of the individual's age at placement) would improve older children's chances for adoption. Finally, the Congress believed that these simpler rules might encourage more families to provide foster care.

Explanation of Provision

JCWA makes two modifications to the present-law exclusion for qualified foster care payments. First, JCWA expands the definition of qualified foster care payments to include payments by any placement agency that is licensed or certified by a State or local government, or an entity designated by a State or local government to make payments to providers of foster care. Second, JCWA expands the definition of a qualified foster care individual by including foster care individuals placed by a qualified foster care placement agency (regardless of the individual's age at the time of placement).

²⁶³ A difficulty of care payment is a payment designated by the person making such payment as compensation for providing the additional care of a qualified foster care individual in the home of the foster care provider which is required by reason of a physical, mental, or emotional handicap of such individual and with respect to which the State has determined that there is a need for additional compensation.

²⁶⁴ See H.R. 586, the "Fairness for Foster Care Families Act of 2001," which was reported by the House Committee on Ways and Means on May 15, 2001 (H. R. Rep. 107-66).

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$17 million in 2002, \$29 million in 2003, \$36 million in 2004, \$44 million in 2005, \$52 million in 2006, \$61 million in 2007, \$70 million in 2008, \$80 million in 2009, \$90 million in 2010, \$101 million in 2010, and \$112 million in 2011.

E. Interest Rate Used in Determining Additional Required Contributions to Defined Benefit Plans and PBGC Variable Rate Premiums (sec. 405 of the Act, sec. 412 of the Code, and secs. 302 and 4006 of ERISA)

Present and Prior Law***In general***

ERISA and the Code impose both minimum and maximum²⁶⁵ funding requirements with respect to defined benefit pension plans. The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to the plan. The amount of contributions required for a plan year is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit.

Additional contributions for certain plans

Additional contributions are required under a special funding rule for certain single-employer defined benefit pension plans²⁶⁶ if the value of the plan assets is less than 90 percent of the plan's current liability.²⁶⁷ The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage."

If a plan is subject to the special rule, the amount of additional required contributions for a plan year is based on certain elements, including whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). However, the amount of additional contributions cannot exceed the

²⁶⁵ The maximum funding requirement for a defined benefit plan is referred to as the full funding limitation. Additional contributions are not required if a plan has reached the full funding limitation.

²⁶⁶ Plans with no more than 100 participants on any day in the preceding plan year are not subject to the special funding rule. Plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

²⁶⁷ Under an alternative test, a plan is not subject to the special rule if (1) the value of the plan assets is at least 80 percent of current liability and (2) the value of the plan assets was at least 90 percent of current liability for each of the two immediately preceding years or each of the second and third immediately preceding years.

amount needed to increase the plan's funded current liability percentage to 100 percent.

Required interest rate

In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.²⁶⁸ The permissible range is from 90 percent to 105 percent. As a result of debt reduction, the Department of the Treasury does not currently issue 30-year Treasury securities.

Timing of plan contributions

In general, plan contributions required to satisfy the funding rules must be made within 8½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.²⁶⁹

PBGC premiums

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. In order to protect employees and their beneficiaries, the Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans. Employers pay premiums to the PBGC for this insurance coverage.

In the case of an underfunded plan, additional PBGC premiums are required based on the amount of unfunded vested benefits. These premiums are referred to as "variable rate premiums." In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Explanation of Provision

Additional contributions

JCWA expands the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of ap-

²⁶⁸ The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan (section 412(b)(5)(B)(iii)(II)).

²⁶⁹ No additional quarterly contributions are due once the plan's funded current liability percentage for the plan year reaches 100 percent.

plying the additional contribution requirements for plan years beginning after December 31, 2001, and before January 1, 2004. Under JCWA, the permissible range is from 90 percent to 120 percent for these years. Use of a higher interest rate under the expanded range will affect the plan's current liability, which may in turn affect the need to make additional contributions and the amount of any additional contributions.

Because the quarterly contributions requirements are based on current liability for the preceding plan year, JCWA also provides special rules for applying these requirements for plans years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability percentage for the preceding year, which may affect the need to make quarterly contributions and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

PBGC variable rate premiums

Under JCWA, the interest rate used in determining the amount of unfunded vested benefits for variable rate premium purposes is increased to 100 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.²⁷⁰

Effective Date

The provision is effective with respect to plan contributions and PBGC variable rate premiums for plan years beginning after December 31, 2001, and before January 1, 2004.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by \$1,953 million in 2002, \$3,979 million in 2003, \$346 million in 2004 and reduce Federal fiscal year budget receipts by, \$2,478 million in 2005, \$1,316 million in 2006, \$1,624 million in 2007, \$1,764 million in 2008, \$1,204 million in 2009, \$714 million in 2010, \$210 million in 2011, and \$30 million in 2012.

F. Adjusted Gross Income Determined by Taking into Account Certain Expenses of Elementary and Secondary School Teachers (sec. 406 of the Act and sec. 62 of the Code)

Present and Prior Law

In general, ordinary and necessary business expenses are deductible (sec. 162). However, unreimbursed employee business expenses

²⁷⁰Section 2(d) of the Tax Technical Corrections Act of 2002, introduced on November 13, 2002, as H.R. 5713 in the House of Representatives and S. 3153 in the Senate, would make conforming changes so that this rule applies for purposes of notices and reporting required under Title IV of ERISA with respect to underfunded plans.

are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income.

An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of \$137,300 (for 2002).²⁷¹ In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Explanation of Provision

JCWA provides an above-the-line deduction for taxable years beginning in 2002 and 2003 for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school which provides elementary education or secondary education, as determined under State law.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2004.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$152 million in 2002, \$205 million in 2003, \$52 million in 2004.

Subtitle B—Tax Technical and Additional Corrections

Except as otherwise provided, the technical and additional corrections contained in JCWA generally are effective as if included in the originally enacted related legislation.

²⁷¹ The effect of this overall limitation is phased down beginning in 2006, and is repealed for 2010 by section 103 of EGTRRA, described in Part Two, Section 1 of this document.

A. Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001 (sec. 411(a)—(h) of the Act)

1. Section 6428 credit interaction with refundable child tax credit

The provision treats the section 6428 credit (rate reduction) like a nonrefundable personal credit, thus allowing it prior to determining the refundable child credit.

2. Child tax credit

The provision clarifies that for taxable years beginning in 2001, the portion of the child credit that is refundable is determined by referring in Code section 24(d)(1)(B) to “the aggregate amount of credits allowed by this subpart.” This would retain prior law that was inadvertently changed by the Act.

3. Transition rule for adoption tax credit

Under prior law, the maximum amount of adoption expenses which could be taken into account in computing the adoption tax credit for any child was \$5,000 (\$6,000 in the case of special needs adoptions). Under prior and present law, the credit generally is allowed in the taxable year following the taxable year the expenses are paid or incurred where expenses are paid or incurred before the taxable year the adoption becomes final. The Act increased the maximum amount of expenses to \$10,000 for taxable years beginning after 2001, but did not include a provision describing the dollar limit for amounts paid or incurred during taxable years beginning before January 1, 2002, for adoptions that do not become final in those years. The provision clarifies that amount of expenses paid or incurred during taxable years beginning before January 1, 2002, which are taken into account in determining a credit allowed in a taxable year beginning after December 31, 2001, are subject to the \$5,000 (or \$6,000) dollar cap in effect immediately prior to the enactment of the Act.

4. Dollar amount of credit for special needs adoptions

The provision clarifies that, for special needs adoptions that become final in taxable years beginning after 2002, the adoption expenses taken into account are increased by the excess (if any) of \$10,000 over the aggregate adoption expenses for the taxable year that the adoption becomes final and all prior taxable years.

5. Employer-provided adoption assistance exclusion with respect to special needs adoptions

The provision clarifies that, for taxable years beginning after 2002, the amount of adoption expenses taken into account in determining the exclusion for employer-provided adoption assistance in the case of a special needs adoption is increased by the excess (if any) of \$10,000 over the aggregate qualified adoption expenses with respect to the adoption for the taxable year the adoption becomes final and all prior taxable years.

6. Credit for employer expenses for child care assistance

The provision clarifies that recapture tax with respect to this credit is treated like recapture taxes with respect to other credits under chapter 1 of the Code. Thus, it would not be treated as a tax for purposes of determining the amounts of other credits or determining the amount of alternative minimum tax.

7. Elimination of marriage penalty in standard deduction

The provision provides rules that were inadvertently omitted providing for separate returns and rounding rules for the standard deduction for the transition period years.

8. Education IRAs; non-application of 10-percent additional tax with respect to amounts for which HOPE credit is claimed

Under the law prior to the Act, taxpayers could not claim the HOPE (or Lifetime learning) credit in the same year that they claimed an exclusion from income from an education IRA. Taxpayers were permitted to waive the exclusion in order to claim the HOPE (or Lifetime learning) credit. For taxpayers electing the waiver, earnings from amounts withdrawn from education IRAs and attributable to education expenses for which a HOPE (or Lifetime learning) credit was claimed were includable in income, but the additional ten percent tax was not applied. Under the Act, taxpayers are permitted to claim the education IRA exclusion and claim a HOPE (or Lifetime learning) credit in the same year, provided they do not claim both with respect to the same educational expenses. The election to waive the education IRA exclusion was thus unnecessary, and was dropped. However, a reference to the election was retained (section 530(d)(4)(b)(iv)). The reference to the election was intended to preserve the rule relating to the non-application of the 10-percent additional tax for education IRA earnings that are includable in income solely because the HOPE (or Lifetime learning) credit is claimed for those expenses. The provision clarifies the present-law rules to reflect this result.

The provision prevents the 10-percent additional tax from applying to a distribution from an education IRA (or qualified tuition program) that is used to pay qualified higher education expenses, but the taxpayer elects to claim a HOPE or Lifetime Learning credit in lieu of the exclusion under section 530 or 529. Thus, the income distributed from the education IRA (or qualified tuition program) would be subject to income tax, but not to the 10-percent additional tax.

9. Transfers in trust

The provision clarifies that the effect of section 511(e) of the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010.

For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511-2(c). Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life, and makes no transfer of a remainder interest, the entire value of the property will be treated as being transferred by gift under the provision.

10. Recovery of taxes claimed as credit (State death tax credit)

The provision eliminates as deadwood a reference to the State death tax credit.

B. Pension-Related Amendments to the Economic Growth and Tax Relief Reconciliation Act of 2001 (sec. 411(i)—(w) of the Act)

1. Individual Retirement Arrangements (“IRAs”)

Under the Act, a qualified employer plan may provide for voluntary employee contributions to a separate account that is deemed to be an IRA. The provision clarifies that, for purposes of deemed IRAs, the term “qualified employer plan” includes the following types of plans maintained by a governmental employer: a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity plan under section 403(b), and an eligible deferred compensation plan under section 457(b). The provision also clarifies that ERISA is intended to apply to a deemed IRA in a manner similar to a simplified employee pension (“SEP”).

2. Increase in benefit and contribution limits

Under the Act, the benefit and contribution limits that apply to qualified retirement plans are increased. These increases are generally effective for years beginning after December 31, 2001, but the increase in the limit on benefits under a defined benefit plan is effective for years ending after December 31, 2001. In the case of some plans that incorporate the benefit limits by reference and that use a plan year other than the calendar year, the increased benefit limits became effective under the plan automatically, causing unintended benefit increases. The provision permits an employer to amend such a plan by June 30, 2002, to reduce benefits to the level that applied before enactment of the Act without violating the anticutback rules that generally apply to plan amendments.

In connection with the increases in the benefit and contribution limits under the Act, a new base period applies in indexing the 2002 dollar amounts for future cost-of-living adjustments. The same indexing method applies to the dollar amounts used to determine eligibility to participate in a SEP and to determine the proper period for distributions from an employee stock ownership plan

(“ESOP”). The provision changes these dollar amounts to the 2002 indexed amounts so that future indexing will operate properly.

3. Modification of top-heavy rules

Under the Act, in determining whether a plan is top-heavy, distributions made because of separation from service, death, or disability are taken into account for one year after distribution. Other distributions are taken into account for five years. The Act also permits distributions from a section 401(k) plan, a tax-sheltered annuity plan, or an eligible deferred compensation plan to be made when the participant has a severance from employment (rather than separation from service). The provision clarifies that distributions made after severance from employment (rather than separation from service) are taken into account for only one year in determining top-heavy status.

4. Elective deferrals not taken into account for deduction limits

The provision clarifies that elective deferrals to a SEP are not subject to the deduction limits and are not taken into account in applying the limits to other SEP contributions. The provision also clarifies that the combined deduction limit of 25 percent of compensation for qualified defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

5. Deduction limits

Under present law, contributions to a SEP are included in an employee’s income to the extent they exceed the lesser of 15 percent of compensation or \$40,000 (for 2002), subject to a reduction in some cases. Under prior law, the annual limitation on the amount of deductible contributions to a SEP was 15 percent of compensation. Under the Act, the annual limitation on the amount of deductible contributions that can be made to a SEP is increased from 15 percent of compensation to 25 percent of compensation. The provision makes a conforming change to the rule that limits the amount of SEP contributions that may be made for a particular employee. Under the provision, contributions are included in an employee’s income to the extent they exceed the lesser of 25 percent of compensation or \$40,000 (for 2002), subject to a reduction in some cases.

Under present law, the Secretary of the Treasury has the authority to require an employer who makes contributions to a SEP to provide simplified reports with respect to such contributions. Consistent with present law and the provision, such reports could appropriately include information as to compliance with the requirements that apply to SEPs, including the contribution limits.

6. Nonrefundable credit for certain individuals for elective deferrals and IRA contributions

The provision clarifies that the amount of contributions taken into account in determining the credit for elective deferrals and IRA contributions is reduced by the amount of a distribution from a qualified retirement plan, an eligible deferred compensation plan,

or a traditional IRA that is includible in income or that consists of after-tax contributions. The provision retains the rule that distributions that are rolled over to another retirement plan do not affect the credit.

7. Small business tax credit for new retirement plan expenses

The provision clarifies that the small business tax credit for new retirement plan expenses applies in the case of a plan first effective after December 31, 2001, even if adopted on or before that date.

8. Additional salary reduction catch-up contributions

Under the Act, an individual age 50 or over may make additional elective deferrals (“catch-up contributions”) to certain retirement plans, up to a specified limit. A plan may not permit catch-up deferrals in excess of this limit. The provision clarifies that, for this purpose, the limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan. The limit applies also to all eligible deferred compensation plans of a government employer on an aggregated basis.

Under the Act, catch-up contributions up to the specified limit are excluded from an individual’s income. The provision also clarifies that the total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up contribution limit for that year (and for that type of plan), without regard to whether the individual made catch-up contributions under plans maintained by the more than one employer.

The provision clarifies that an individual who will attain age 50 by the end of the taxable year is an eligible participant as of the beginning of the taxable year rather than only at the attainment of age 50. The provision also clarifies that a participant in an eligible deferred compensation plan of a government employer may make catch-up contributions in an amount equal to the greater of the amount permitted under the new catch-up rule and the amount permitted under the special catch-up rule for eligible deferred compensation plans.

The provision revises the lists of requirements that do not apply to catch-up contributions to reflect other statutory amendments made by the Act and to reflect the fact that catch-up contributions can be made only to a qualified defined contribution plan, not to a qualified defined benefit plan. The provision also clarifies that the special nondiscrimination rule for mergers and acquisitions applies for purposes of the nondiscrimination requirement applicable to catch-up contributions.

9. Equitable treatment for contributions of employees to defined contribution plans

Under prior law, the limits on contributions to a tax-sheltered annuity plan applied at the time contributions became vested. Under the Act, tax-sheltered annuity plans are generally subject to the same contribution limits as qualified defined contribution plans, but certain special rules were retained.

The provision clarifies that the limits apply to contributions to a tax-sheltered annuity plan in the year the contributions are made without regard to when the contributions become vested. The provision also clarifies that contributions may be made for an employee for up to five years after retirement, based on includible compensation for the last year of service before retirement. The provision also restores special rules for ministers and lay employees of churches and for foreign missionaries that were inadvertently eliminated.

Under the Act, amounts deferred under an eligible deferred compensation plan are generally subject to the same contribution limits as qualified defined contribution plans. The provision conforms the definition of compensation used in applying the limits to an eligible deferred compensation plan to the definition used for qualified defined contribution plans.

10. Rollovers of retirement plan and IRA distributions

Under prior law and under the Act, a qualified retirement plan must provide for the rollover of certain distributions directly to a qualified defined contribution plan, a qualified annuity plan, a tax-sheltered annuity plan, a governmental eligible deferred compensation plan, or a traditional IRA, if the participant elects a direct rollover. The provision clarifies that a qualified retirement plan must provide for the direct rollover of after-tax contributions only to a qualified defined contribution plan or a traditional IRA. The provision also clarifies that, if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts.

11. Employers may disregard rollovers for purposes of cash-out amounts

Under prior and present law, if a participant in a qualified retirement plan ceases to be employed with the employer maintaining the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. Under the Act, a plan may provide that the present value of the benefit is determined without regard to the portion of the benefit that is attributable to rollover contributions (and any earnings allocable thereto) for purposes of determining whether the participant must consent to the cash-out of the benefit. The provision clarifies that rollover amounts may be disregarded also in determining whether a spouse must consent to the cash-out of the benefit.

12. Notice of significant reduction in plan benefit accruals

Under the Act, notice must be provided to participants if a defined benefit plan is amended to provide for a significant reduction in the future rate of benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy. The provision clarifies that the notice requirement applies to a defined benefit plan only if the plan is qualified. The provision further clarifies that, in the case of an amendment that eliminates an early retirement benefit or retirement-type subsidy, notice is re-

quired only if the early retirement benefit or retirement-type subsidy is significant. The provision also eliminates inconsistencies in the statutory language.

13. Modification of timing of plan valuation

Under the Act, a plan valuation may be made as of any date in the immediately preceding plan year if, as of such date, plan assets are not less than 100 percent of the plan's current liability. Under the Act, a change in funding method to use a valuation date in the prior year generally may not be made unless, as of such date, plan assets are not less than 125 percent of the plan's current liability. The provision conforms the statutory language to Congressional intent as reflected in the Statement of Managers.

14. ESOP dividends may be reinvested without loss of dividend deduction

Under prior and present law, a deduction is permitted for a dividend paid with respect to employer stock held in an ESOP if the dividend is (1) paid in cash directly to participants or (2) paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan. The deduction is allowable for the taxable year of the corporation in which the dividend is paid or distributed to the participants.

Under the Act, in addition to the deductions permitted under present law, a deduction is permitted for a dividend paid with respect to employer stock that, at the election of the participants, is payable in cash directly to participants or paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which the dividend is paid to the plan, or paid to the plan and reinvested in qualifying employer securities. Under the provision, the deduction for dividends that are reinvested in qualifying employer securities at the election of participants is allowable for the taxable year in which the later of the reinvestment or the election occurs. The provision also clarifies that a dividend that is reinvested in qualifying employer securities at the participant's election must be nonforfeitable.

C. Amendments to the Community Renewal Tax Relief Act of 2000 (sec. 412 of the Act)

1. Phaseout of \$25,000 amount for certain rental real estate under passive loss rules

Present law provides for a phaseout of the \$25,000 amount allowed in the case of certain deductions and certain credits with respect to rental real estate activities, for taxpayers with adjusted gross income exceeding \$100,000. The phaseout rule does not apply, or applies separately, in the case of the rehabilitation credit, the low-income housing credit, and the commercial revitalization deduction. The provision clarifies the operation of the ordering rules to reflect the exceptions and separate phaseout rules for these items.

2. Treatment of missing children

Present law provides that in the case of a dependent child of the taxpayer that is kidnapped, the taxpayer may continue to treat the child as a dependent for purposes of the dependency exemption, child credit, surviving spouse filing status, and head of household filing status. A similar rule applies under the earned income credit. The provision clarifies that, if a taxpayer met the household maintenance requirement of the surviving spouse filing status or the head of household filing status, respectively, with respect to his or her dependent child immediately before the kidnapping, then the taxpayer would be deemed to continue to meet that requirement for purposes of the filing status rule of section 2 of the Code until the child would have reached age 18 or is determined to be dead.

3. Basis of property in an exchange by a corporation involving assumption of liabilities

The provision clarifies that the basis reduction rule of section 358(h) of the Code gives rise to a basis reduction in the amount of any liability that is assumed by another party as part of the exchange in which the property (whose basis exceeds its fair market value) is received, so long as the other requirements under section 358(h) apply.

4. Tax treatment of securities futures contracts

The provision clarifies that the termination of a securities contract is treated in a manner similar to a sale or exchange of a securities futures contract for purposes of determining the character of any gain or loss from a termination of a securities futures contract. Under the provision, any gain or loss from the termination of a securities futures contract (other than a dealer securities futures contract) is treated as gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer.

The provision also clarifies that losses from the sale, exchange, or termination of a securities futures contract (other than a dealer securities futures contract) to sell generally are treated in the same manner as losses from the closing of a short sale for purposes of applying the wash sale rules. Thus, the wash sale rules apply to any loss from the sale, exchange, or termination of a securities futures contract (other than dealer securities futures contract) if, within a period beginning 30 days before the date of such sale, exchange, or termination and ending 30 days after such date: (1) stock that is substantially identical to the stock to which the contract relates is sold; (2) a short sale of substantially identical stock is entered into; or (3) another securities futures contract to sell substantially identical stock is entered into.

The provision clarifies that a securities futures contract to sell generally is treated in a manner similar to a short sale for purposes of the special holding period rules in section 1233. Thus, subsections (b) and (d) of section 1233 may apply to characterize certain capital gains as short-term capital gain and certain capital losses as long-term capital loss, and to determine holding periods where certain securities futures contracts to sell are entered into while holding the substantially identical stock.

D. Amendment to the Tax Relief Extension Act of 1999 (sec. 413 of the Act)

1. Taxable REIT subsidiaries—100 percent tax on improperly allocated amounts

The provision clarifies that redetermined rents, to which the excise tax applies, are the excess of the amount treated by the REIT as rents from real property under Code section 856(d) over the amount that would be so treated after reduction under Code section 482 to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary of the REIT to a tenant of the REIT. Similarly, redetermined deductions are the excess of the amount treated by the taxable REIT subsidiary as other deductions over the amount that would be so treated after reduction under Code section 482.

E. Amendments to the Taxpayer Relief Act of 1997 (sec. 414 of the Act)

1. Election to recognize gain on assets held on January 1, 2001; treatment of gain on sale of principal residence

The provision clarifies that the gain to which the mark-to-market election applies is included in gross income. Thus, the exclusion of gain on the sale of a principal residence under Code section 121 would not apply with respect to an asset for which the election to mark to market is made. The provision is consistent with the holding of Rev. Rul. 2001-57.

2. Election to recognize gain on assets held on January 1, 2001; treatment of disposition of interest in passive activity

The provision clarifies that the election to mark to market an interest in a passive activity does not result in the deduction of suspended losses by reason of section 469(g)(1)(A). Any gain taken into account by reason of an election with respect to any interest in a passive activity is taken into account in determining the passive activity loss for the taxable year (as defined in section 469(d)(1)). Section 469(g)(1)(A) may apply to a subsequent disposition of the interest in the activity by the taxpayer.

F. Amendment to the Balanced Budget Act of 1997 (sec. 415 of the Act)

1. Medicare+Choice MSA

The provision conforms the treatment of the additional tax on Medicare+Choice MSAs distributions not used for qualified medical expenses if a minimum balance is not maintained to the treatment of the additional tax on Archer MSA distributions not used for qualified medical expenses, for purposes of determining whether certain taxes are included within regular tax liability under Code section 26(b).

G. Amendment to other Acts (sec. 416 of the Act)

1. Advance payments of earned income credit

The provision corrects a reference in section 32(g)(2) to refer to credits allowable under this part (i.e., all tax credits) rather than under this subpart (i.e., the refundable credits). The provision is effective as if included in section 474 of the Tax Reform Act of 1984.

2. Coordination of wash sale rules and section 1256 contracts

The bill clarifies that the wash sale rules do not apply to any loss arising from a section 1256 contract. This rule is similar to the rule in present-law section 475 applicable to securities that are marked to market under that section. The provision is effective as if included in section 5075 of the Technical and Miscellaneous Revenue Act of 1988.

3. Disclosure by the Social Security Administration to Federal child support enforcement agencies

Section 6103(l)(8) permits the Social Security Administration (SSA) to disclose certain tax information in its possession to State child support enforcement agencies. The Office of Child Support Enforcement (OCSE), a Federal agency, oversees child support enforcement at the Federal level and acts as a coordinator for most programs involved with child support enforcement. OCSE acts as a conduit for the disclosure of tax information from the Internal Revenue Service to the various State and local child support enforcement agencies. The change to section 6103(l)(8) permits SSA to make disclosures directly to OCSE, which in turn would make the disclosures to the State and local child support enforcement agencies. The provision is effective on the date of enactment.

4. Treatment of settlements under partnership audit rules

The provision clarifies that the partnership audit procedures that apply to settlement agreements entered into by the Secretary also apply to settlement agreements entered into by the Attorney General. Under present law, when the Secretary enters into a settlement agreement with a partner with respect to partnership items, those items convert to nonpartnership items, and the other partners in the partnership have a right to request consistent settlement terms. The conversion of the settling partner's partnership items to nonpartnership items is the mechanism by which the settling partner is removed from the ongoing partnership proceeding. If these rules did not apply to settlement agreements entered into by the Attorney General (or his delegate), it is possible that a settling partner would inadvertently be bound by the outcome of the partnership proceeding rather than the settlement agreement entered into with the Attorney General (or his delegate) (section 6224(c)(2)). Similar changes are made to related provisions with respect to settlement agreements. The provision is effective for settlement agreements entered into after the date of enactment.

5. Clarification of permissible extension of limitations period for installment agreements

Uncertainty existed as to whether the permissible extension of the period of limitations in the context of installment agreements is governed by reference to an agreement of the parties pursuant to section 6502 or by reference to the period of time during which the installment agreement is in effect pursuant to sections 6331(k)(3) and (i)(5). A 2000 technical correction clarified that the permissible extension of the period of limitations in the context of installment agreements is governed by the pertinent provisions of section 6502. The provision further clarifies that the elimination of the application of the section 6331(i)(5) rules applies only to section 6331(k)(2)(C). The provision modifies section 313(b)(3) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554). This is the further technical correction referred to in footnote 185a, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, page 162. The provision is effective on the date of enactment.

6. Determination of whether a life insurance contract is a modified endowment contract

The provision clarifies that, for purposes of determining whether a life insurance contract is a modified endowment contract, if there is a material change to the contract, appropriate adjustments are made in determining whether the contract meets the 7-pay test to take into account the cash surrender value under the contract. No reference is needed to the cash surrender under the “old contract” (as was provided under section 318(a)(2) of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (Pub. Law No. 106-554)) because prior and present law provide a definition of cash surrender value for this purpose (by cross reference to section 7702(f)(2)(A)). It is reiterated that Code section 7702A(c)(3)(ii) is not intended to permit a policyholder to engage in a series of “material changes” to circumvent the premium limitations in section 7702A. Thus, if there is a material change to a life insurance contract, it is intended that the fair market value of the contract be used as the cash surrender value under the provision, if the amount of the putative cash surrender value of the contract is artificially depressed. For example, if there is a material change because of an increase in the face amount of the contract, any artificial or temporary reduction in the cash surrender value of the contract is not to be taken into account, but rather, it is intended that the fair market value of the contract be used as cash surrender value, so that the substance rather than the form of the transaction is reflected. Further, as stated in the 1988 Act legislative history to section 7702A,²⁷² in applying the 7-pay test to any premiums paid under a contract that has been materially changed, the 7-pay premium for each of the first 7 contract years after the change is to be reduced by the product of (1) the cash surrender value of the contract as of the date that the material change takes effect (determined

²⁷²The conference Report to accompany H.R. 4333, the “Technical and Miscellaneous Revenue Act of 1988,” (H.R. Rep. No. 100-1104), Oct. 21, 1988, Vol. II, p. 105.

without regard to any increase in the cash surrender value that is attributable to the amount of the premium payment that is not necessary), and (2) a fraction the numerator of which equals the 7-pay premium for the future benefits under the contract, and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 7-pay premium. The provision is effective as if section 318(a) of the Community Renewal Tax Relief Act of 2000 (114. Stat. 2763A-645) had not been enacted.

H. Clerical Amendments (sec. 417 of the Act)

The bill makes a number of clerical and typographical amendments to the Code.

I. Additional Corrections (sec. 418 of the Act)

1. Adoption credit and employer-provided adoption assistance exclusion rounding rules

The provision provides uniform rounding rules (to the nearest multiple of \$10) for the inflation-adjusted dollar limits and income limitations in the adoption credit and the employer-provided adoption assistance exclusion. The provision is effective as if included in the provision of the Economic Growth and Tax Reform Reconciliation Act of 2001 to which it relates.

2. Dependent care credit

The provision conforms the dollar limit on deemed earned income of a taxpayer's spouse who is either (1) a full-time student, or (2) physically or mentally incapable of caring for himself, to the dollar limit on employment-related expenses applicable in determining the maximum credit amount. The 2001 Act increased the dollar limit on employer-related expenses to \$3,000 for one qualifying individual or \$6,000 for two or more qualifying individuals annually but did not conform the dollar limit on deemed earned income of a spouse. The provision is effective as if included in the provision of the Economic Growth and Tax Reform Reconciliation Act of 2001 to which it relates.

Revenue Effect

The additional corrections are estimated to reduce Federal fiscal year budget receipts by \$1 million annually in 2003 through 2009 and by less than \$500,000 annually in 2010 and 2011.

TITLE IV. NO IMPACT ON SOCIAL SECURITY TRUST FUNDS (Sec. 501 of the Act)

Present Law

Present Law provides for the transfer of Social Security taxes and certain self-employment taxes to the Social Security trust fund. In addition, the income tax collected with respect to a portion of Social Security benefits included in gross income is transferred to the Social Security trust fund.

Explanation of Provision

JCWA provides that the Secretary is to annually estimate the impact of JCWA on the income and balances of the Social Security trust fund. If the Secretary determines that JCWA has a negative impact on the income and balances of the fund, then the Secretary is to transfer from the general revenues of the Federal government an amount sufficient so as to ensure that the income and balances of the Social Security trust funds are not reduced as a result of the bill. Such transfers are to be made not less frequently than quarterly.

Job Creation and Workers Assistance provides that the provisions of JCWA are not to be construed as an amendment of Title II of the Social Security Act.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effects on Federal fiscal year budget receipts.

TITLE V. EMERGENCY DESIGNATION (Sec. 502 of the Act)

Present Law

Under the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, any legislation that reduces revenues or increases outlays is subject to a pay-as-you-go (“PAYGO”) requirement. The PAYGO system tracks legislation that may increase budget deficits using a “scorecard” estimated by the Office of Management and Budget. Under PAYGO requirements, in order to avoid sequestration, any revenue loss or increase in outlays would need to be offset by revenue increases or reductions in direct spending.

If a provision of direct spending or receipts legislation is enacted that the President designates as an emergency requirement and that the Congress so designates in statute, the amounts of new budget authority, outlays, and receipts in all fiscal years resulting from that provision are not taken into account in determining the PAYGO scorecard.

Explanation of Provision

JCWA designates any revenue loss, new authority, and new outlays under the bill in excess of those allowed under the FY 2002 budget resolution as emergency requirements pursuant to section 252(e) of the Balanced Budget and Emergency Deficit Control Act of 1985.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

This provision is estimated to have no effects on Federal fiscal year budget receipts.

TITLE VI. EXTENSIONS OF EXPIRING PROVISIONS

A. Extend Alternative Minimum Tax Relief for Individuals (sec. 601 of the Act and sec. 26 of the Code)

Present and Prior Law

Prior and present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,²⁷³ the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit). Under prior law, for taxable years beginning after 2001, these credits (other than the adoption credit, child credit, and IRA credit) were allowed only to the extent that the individual's regular income tax liability exceeded the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. Under present and prior law, the adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

For taxable years beginning in 2001, all the nonrefundable personal credits were allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to: (1) 26 percent of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) \$45,000 (\$49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 (\$35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) \$22,500 (\$24,500 in taxable years beginning before 2005) in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds: (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate

²⁷³A portion of the child credit may be refundable.

returns or an estate or a trust. These amounts are not indexed for inflation.

Reasons for Change

The Congress believed that the nonrefundable personal credits should be useable without limitation by reason of the alternative minimum tax. This will result in significant simplification.

Explanation of Provision

JCWA allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal non-refundable credits in 2002 and 2003.

Effective Date

The provision is effective for taxable years beginning in 2002 and 2003.

Revenue Effect

The provision is expected to reduce fiscal year budget receipts by \$85 million in 2002, \$444 million in 2003, and \$424 million in 2004.

**B. Extend Credit for Purchase of Qualified Electric Vehicles
(sec. 602 of the Act and secs. 30 and 280F of the Code)**

Present and Prior Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of \$4,000 (section 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electric current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. Under prior law, the credit phased down in the years 2002 through 2004, and was unavailable for purchases after December 31, 2004.²⁷⁴

Reasons for Change

The Congress believed that continued economic incentive is warranted to increase the presence of electric vehicles on the nation's roadways.

Explanation of Provision

JCWA defers the phase down of the credit by two years. Taxpayers may claim the full amount of the credit for qualified purchases made in 2002 and 2003. Under JCWA, the phase down of the credit value commences in 2004 and the credit is unavailable

²⁷⁴The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the otherwise applicable limitation amounts are tripled. Under prior law, these exceptions from sec. 280F applied to vehicles placed in service prior to January 1, 2005.

for purchases after December 31, 2006. A conforming modification is made to section 280F.

Effective Date

The provision is effective for property placed in service after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year receipts by \$25 million in 2002, \$43 million in 2003, \$41 million in 2004, \$34 million in 2005, and \$20 million in 2006. The provision is estimate to increase Federal fiscal year receipts by \$1 million in 2007, \$6 million in 2008, \$4 million in 2009, \$2 million in 2010, \$1 million in 2011, and by less than \$500,000 in 2012.

C. Extend Section 45 Credit for Production of Electricity from Wind, Closed Loop Biomass, and Poultry Litter (sec. 603 of the Act and sec. 45 of the Code)

Present and Prior Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified “closed-loop” biomass, or qualified poultry waste facilities (section 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit is 1.8 cents per kilowatt hour for electricity produced in 2002.²⁷⁵

Under prior law, the credit applied to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to electricity produced by a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (section 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer’s net income tax over

²⁷⁵The amount of the credit was 1.7 cents per kilowatt hour for 2001.

the greater of (1) 25 percent of net regular tax liability above \$25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (section 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (section 39).

Reasons for Change

The Congress believed that continued economic incentive is warranted to increase the presence of these more environmentally friendly generation sources in the nation's electricity grid.

Explanation of Provision

JCWA extends the placed in service date for qualified facilities by two years to include those facilities placed in service prior to January 1, 2004.

Effective Date

The provision is effective facilities placed in service after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year receipts by \$11 million in 2002, \$40 million in 2003, \$72 million in 2004, \$96 million in 2005, \$108 million in 2006, \$113 million in 2007, \$115 million in 2008, \$116 million in 2009, \$119 million in 2010, \$121 million in 2011, and \$97 million in 2012.

D. Extend the Work Opportunity Tax Credit (sec. 604 of the Act and sec. 51 of the Code)

Present and Prior Law

In general

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (“TANF”) Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (“SSI”) benefits.

The employer’s deduction for wages is reduced by the amount of the credit.

Expiration date

Under prior law, the credit was effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2002.

Reasons for Change

The Congress believed that a temporary extension of this credit would allow the Congress and the Treasury and Labor Departments to continue to monitor the effectiveness of the credit.

Explanation of Provision

JCWA extends the work opportunity tax credit for two years (through December 31, 2003).

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$96 million in 2002, \$227 million in 2003, \$173 million in 2004, \$62 million in 2005, \$35 million in 2006, \$21 million in 2007 and \$7 million in 2008.

E. Extend the Welfare-To-Work Tax Credit (sec. 605 of the Act and sec. 51A of the Code)***Present and Prior Law******In general***

The welfare-to-work tax credit is available on an elective basis for employers for the first \$20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first \$10,000 of eligible wages in the first year of employment and 50 percent of the first \$10,000 of eligible wages in the second year of employment. The maximum credit is \$8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family

that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within two years after the date that the 18-month total is reached; and (3) members of a family that is no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families (“TANF”) program.

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer’s deduction for wages is reduced by the amount of the credit.

Expiration date

Under prior law, the welfare to work credit was effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2002.

Reasons for Change

The Congress believed that the welfare-to-work credit should be temporarily extended to provide the Congress and the Treasury and Labor Departments a better opportunity to assess the operation and effectiveness of the credit in meeting its goals. These goals are: (1) to provide an incentive to hire long-term welfare recipients; (2) to promote the transition from welfare to work by increasing access to employment for these individuals; and (3) to encourage employers to provide these individuals with training, health coverage, dependent care and ultimately better job attachment.

Explanation of Provision

JCWA extends the welfare to work credit for two years (through December 31, 2003).

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$30 million in 2002, \$76 million in 2003, \$61 million in 2004, \$22 million in 2005, \$12 million in 2006, \$7 million in 2007 and \$3 million in 2008.

F. Extend Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean-Fuel Vehicle Refueling Property (sec. 606 of the Act and secs. 179A and 280F of the Code)

Present and Prior Law

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (section 179A).²⁷⁶ Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is \$50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with a seating capacity of at least 20 adults; \$5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and \$2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction.

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is at the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to \$100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location.

Under prior law, the deduction for clean-fuel vehicle property phased down in the years 2002 through 2004, and was unavailable for purchases after December 31, 2004. Under prior law, the deduction for clean-fuel vehicle refueling property was unavailable for property placed in service after December 31, 2004.

Reasons for Change

The Congress believed that continued economic incentive is warranted to increase the presence of alternative fuel vehicles in the market.

Explanation of Provision

JCWA defers the phase down of the deduction for clean-fuel vehicle property by two years. Taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in 2002 and 2003. Under JCWA, the phase down of the deduction for clean-fuel vehicles commences in 2004 and the deduction is unavailable for purchases after December 31, 2006. A conforming modification is made to section 280F.

²⁷⁶The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (section 280F). In the case of a qualified clean-burning fuel vehicle, the limitation of section 280F applies only to that portion of the vehicle's cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel property, without regard to the limitation. Under prior law, these exceptions from section 280F applied to vehicles placed in service prior to January 1, 2005.

JCWA extends the placed in service date for clean-fuel vehicle refueling property by two years. The deduction for clean-fuel vehicle refueling property is available for property placed in service prior to January 1, 2007.

Effective Date

The provision is effective for property placed in service after December 31, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year receipts by \$32 million in 2002, \$116 million in 2003, \$127 million in 2004, \$109 million in 2005, and \$46 million in 2006. The provision is estimate to increase Federal fiscal year receipts by \$63 million in 2007, \$80 million in 2008, \$50 million in 2009, \$29 million in 2010, \$12 million in 2011, and \$3 million in 2012.

G. Taxable Income Limit on Percentage Depletion for Marginal Production (sec. 607 of the Act and sec. 613A of the Code)

Present and Prior Law

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset—in the case of depletion for oil or gas interests, the mineral reserve itself—is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling). Depletion is available to any person having an economic interest in a producing property.

Two methods of depletion are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611–613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (section 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (section 613(a)). The Taxpayer Relief Act of 1997 suspended the 100-percent-of-net-income limitation for production from marginal wells for taxable years beginning after December 31, 1997, and before January 1, 2000. The limitation subsequently was extended to include taxable years beginning before January 1, 2002. Additionally, the percentage depletion deduction for all oil and gas

properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (section 613A(d)(1)).²⁷⁷ Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (section 613(a)).

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (section 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Reasons for Change

The Congress noted that oil is, and will continue to be, vital to the American economy. The Congress believed that extension of the current waiver of the 100-percent-of-income-limit would contribute to investment in domestic oil and gas production.

Explanation of Provision

JCWA extends the period when the 100-percent net-income limit is suspended to include taxable years beginning after December 31, 2001 and before January 1, 2004.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

²⁷⁷ Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by \$21 million in 2002, \$35 million in 2003, and \$13 million in 2004.

H. Extension of Authority to Issue Qualified Zone Academy Bonds (sec. 608 of the Act and sec. 1397E of the Code)

Present and Prior Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (section 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds” (“QZABs”) (section 1397E). Before enactment of the JCWA, a total of \$400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2001. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

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

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase

graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Reasons for Change

The Congress believed that extension of authority to issue qualified zone academy bonds is appropriate in light of the educational needs that exist today.

Explanation of Provision

JCWA authorizes issuance of up to \$400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is expected to reduce Federal fiscal year budget receipts by less than \$500,000 in 2002, \$2 million in 2003, \$7 million in 2004, \$14 million in 2005, \$19 million in 2006, and \$21 million annually in 2007 through 2012.

I. Extension of Increased Coverover Payments to Puerto Rico and the Virgin Islands (sec. 609 of the Act and sec. 7652 of the Code)

Present and Prior Law

A \$13.50 per proof gallon²⁷⁸ excise tax is imposed on distilled spirits produced in, or imported or brought into, the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of \$13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2001. Effective on January 1, 2002, the coverover rate was scheduled to return to its permanent level of \$10.50 per proof gallon.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

Reasons for Change

The Congress believed that extension of the increased coverover rate to Puerto Rico and the Virgin Islands would contribute to economic stability in those possessions.

²⁷⁸A proof gallon is a liquid gallon consisting of 50 percent alcohol.

Explanation of Provision

JCWA extends the \$13.25-per-proof-gallon coverover rate for two additional years, through December 31, 2003.

The Congress is aware that Puerto Rico currently allocates a portion of the coverover payments it receives to the Puerto Rico Conservation Trust. The Congress believes it is appropriate that this allocation continue through the period when the \$13.25-per-proof-gallon rate is extended.

Effective Date

The provision is effective for articles brought into the United States after December 31, 2001.

Revenue Effect

The provision is expected to decrease Federal fiscal year budget receipts by \$65 million in 2002, \$61 million in 2003, and \$14 million in 2004.

J. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 610 of the Act and sec. 9812(f) of the Code)

Present and Prior Law

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, and expired with respect to benefits for services furnished on or after September 30, 2001.

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to \$100 per day during the period of noncompliance and is imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or \$500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

Under prior law, the excise tax initially was applicable with respect to plan years beginning on or after January 1, 1998, and expired with respect to benefits for services provided on or after September 30, 2001. Section 701 of Public Law 107-116 (providing appropriations for the Departments of Labor, Health and Human Services, and Education for fiscal year 2002), enacted January 10, 2002, restored retroactively the mental health parity requirements and the related excise tax to September 30, 2001, and provides that

the provisions are to expire with respect to benefits provided for services on or after December 31, 2002.

Reasons for Change

The Congress believed it appropriate to provide an extension of the mental health parity provisions.

Explanation of Provision

With respect to services provided on or after September 30, 2001, the excise tax on failures to comply with mental health parity requirements is amended to apply to benefits for such services provided on or after January 10, 2002, and before January 1, 2004.²⁷⁹

Effective Date

The provision is effective with respect to plan years beginning after December 31, 2000.

Revenue Effect

The Joint Committee on Taxation estimates that the provision will have a negligible effect on excise tax receipts. The Congressional Budget Office estimates that the provision will have indirect effects on income and payroll tax revenues. CBO estimates that these revenues will decline by \$30 million in 2003 and \$10 million in 2004.

K. Suspension of Reduction of Deductions for Mutual Life Insurance Companies (sec. 611 of the Act and sec. 809 of the Code)

Present and Prior Law

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance

²⁷⁹ Pub. L. No. 107-313, the "Mental Health Parity Reauthorization Act of 2002," enacted December 2, 2002, amends ERISA and the Public Health Service Act to extend the mental health parity requirements through December 31, 2003.

companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present and prior law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

Explanation of Provision

JCWA provides a zero rate for both the differential earnings rate and recomputed differential earnings rate ("true-up") for a life insurance company's taxable years beginning in 2001, 2002, or 2003, under the rules requiring reduction in certain deductions of mutual life insurance companies (section 809).

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$29 million in 2002, \$53 million annually in 2003 and 2004, \$26 million in 2005, \$3 million in 2006, and less than \$500,000 in 2007.

L. Extension of Archer Medical Savings Accounts ("MSAs") (sec. 612 of the Act and sec. 220 of the Code)

Present and Prior Law

In general

Within limits, contributions to a an Archer medical savings account ("MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA

for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.²⁸⁰ An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., “above the line”). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual’s employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least \$1,650 and no more than \$2,500 in the case of individual coverage and at least \$3,300 and no more than \$4,950 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than \$3,300 in the case of individual coverage and no more than \$6,050 in the case of family coverage.²⁸¹ A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Taxation of distributions

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.²⁸² However, in any year for which a con-

²⁸⁰ Self-employed individuals include more than 2-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

²⁸¹ These dollar amounts are for 2002. These amounts are indexed for inflation in \$50 increments.

²⁸² This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

tribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.²⁸³ For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includable in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

Cap on taxpayers utilizing Archer MSAs

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a “cut-off” year) then, in general, for succeeding years during the pilot period 1997–2002, only those individuals who: (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer MSA participants) or (2) are employed by a participating employer, those individuals are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.²⁸⁴ However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of Archer MSAs established has not exceeded the threshold level.

End of Archer MSA pilot program

After 2002, no new contributions could be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if: (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made Archer MSA contributions of at least \$100 in the year 2001.

²⁸³ The exclusion continues to apply to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even for an individual who is not an eligible individual.

²⁸⁴ Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

Self-employed individuals who made contributions to an Archer MSA during the period 1997–2002 also may continue to make contributions after 2002.

Reasons for Change

Archer MSAs were enacted to provide additional health insurance options and to give individuals more control over their health care dollars by providing incentives for individuals to be more cost conscious consumers of health care. The Congress believed that an extension of the Archer MSA program was appropriate in order to continue to pursue such objectives.

Explanation of Provision

The provision extends the Archer MSA program for another year, through December 31, 2003.

Effective Date

The provision is effective on the January 1, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than \$500,000 in 2003 and \$2 million annually in 2004–2012.

M. Extension of Tax Incentives for Investment on Indian Reservations (sec. 613 of the Act and secs. 45A and 168(j) of the Code)

Present and Prior Law

Present and prior law provide the following tax incentives in order to encourage investment on Indian reservations.

Indian employment credit

A general business credit is available for an employer of qualified employees that work on an Indian reservation.²⁸⁵ The credit is equal to 20 percent of the excess of qualified wages and health insurance costs paid to qualified employees in the current year over the amount paid in 1993, up to a maximum of \$20,000. Wages for which the work opportunity credit is available are not qualified wages and are not eligible for the credit.

Employees generally are qualified employees if they (or their respective spouses) are enrolled in an Indian tribe and live on or near the Indian reservation where they work, perform services that are all or substantially all within an Indian reservation, and do not receive wages greater than \$30,000 (adjusted for inflation after 1994) for the taxable year. The credit is not available for employees involved in certain gaming activities or who work in a building that houses certain gaming activities.

Under prior law, the Indian employment credit would not be available after December 31, 2003.

²⁸⁵Section 45A.

Accelerated depreciation of property on Indian reservations

A special depreciation recovery period is available to qualified Indian reservation property.²⁸⁶ In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. Property used to conduct or house certain gaming activities is not qualified Indian reservation property.

The applicable recovery period for qualified Indian reservation property is as follows:

In the case of	The applicable recovery period is
3 year property	2 years.
5 year property	3 years.
7 year property	4 years.
10 year property	6 years.
15 year property	9 years.
20 year property	12 years.
Nonresidential real property	22 years.

Under prior law, accelerated depreciation of property on Indian reservations would not be available for property placed in service after December 31, 2003.

Explanation of Provision

JCWA extends through December 31, 2004, the Indian employment credit and the accelerated depreciation rules for property on Indian reservations.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is expected increase Federal fiscal year budget receipts by \$8 million in 2003, reduce receipts by \$163 million in 2004, \$294 million in 2005, and \$108 million in 2006, and increase Federal fiscal year budget receipts by \$23 million in 2007, \$79 million in 2008, \$123 million in 2009, \$100 million in 2010, \$54 million in 2011, and \$7 million in 2012.

N. Extension and Modification of Exceptions under Subpart F for Active Financing Income (sec. 614 of the Act and secs. 953 and 954 of the Code)***Present and Prior Law***

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently

²⁸⁶Section 168(j).

on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.²⁸⁷

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").²⁸⁸

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income

²⁸⁷ Prop. Treas. Reg. sec. 1.953-1(a).

²⁸⁸ Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002.

derived from certain cross-border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of section 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

A temporary exception from foreign personal holding company income is also provided for income from investment of assets equal to 10 percent of reserves (determined for purposes of the provision) for contracts regulated in the country in which sold as life insurance or annuity contracts. This exception does not apply to investment income with respect to excess surplus.

Reasons for Change

In the Taxpayer Relief Act of 1997, one-year temporary exceptions from foreign personal holding company income were enacted for income from the active conduct of an insurance, banking, financing, or similar business.²⁸⁹ In the Tax and Trade Relief Extension Act of 1998, the Congress extended the temporary exceptions for an additional year, with certain modifications designed to treat various types of businesses with active financing income more similarly to each other than did the 1997 provision.²⁹⁰ In the Tax Relief Extension Act of 1999, Congress extended the temporary extensions for an additional two years, as modified by the 1998 Act, and with a clarification relating to the application of prior law in the event of future non-application of the temporary provisions.²⁹¹ The Congress believed that it is appropriate to extend²⁹² the temporary provisions, as modified by the previous legislation, with an additional modification relating to the determination of certain reserves for life insurance and annuity contracts. The Congress believed that the use of foreign statement reserves for exempt life insurance and annuity contracts may be appropriate under these exceptions in certain circumstances, provided IRS approval is obtained, based on whether such use with respect to those foreign contracts provides an appropriate means of measuring income for Federal income tax purposes.

Explanation of Provision

JCWA extends for five years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

JCWA generally retains present and prior law with respect to the determination of an insurance company's reserve for a life insurance or annuity contract under these exceptions. JCWA does, however, permit a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve for such contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal in-

²⁸⁹ The President canceled this provision in 1997 pursuant to the Line Item Veto Act. On June 25, 1998, the Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. *Clinton v. City of New York*, 524 U.S. 417 (1998).

²⁹⁰ The Tax and Trade Relief Extension Act of 1998, Division J, Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 1999, Pub. L. No. 105-277, sec. 1005 (1998).

²⁹¹ The Tax Relief Extension Act of 1999, Pub.L. No. 106-170, sec. 503 (1999).

²⁹² The House bill, H.R. 3090, the "Economic Security and Recovery Act of 2001," provided for a permanent extension. See H. R. Rep. No. 107-251 at 50 (2001). The Senate bill, the "Economic Recovery and Assistance for American Workers Act of 2001," provided for a one-year extension. See S. Prt. No. 107-49 at 58-60 (2001).

come tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. Present and prior law continues to apply with respect to reserves for any life insurance or annuity contract for which the IRS has not approved the use of the foreign statement reserve. An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2001, and before January 1, 2007, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$315 million in 2002, \$1,490 million in 2003, \$1,684 million in 2004, \$1,903 million in 2005, \$2,129 million in 2006, and \$1,520 million in 2007.

O. Repeal of Dyed-Fuel Requirement for Registered Diesel or Kerosene Terminals (sec. 615 of the Act and sec. 4101 of the Code)

Prior Law

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel.²⁹³ One such exception allows removal of diesel fuel or kerosene without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under prior law, a prerequisite to registration was that if the terminal offered for sale diesel fuel, it had to offer both dyed and undyed diesel fuel. Similarly, if the terminal offered for sale kerosene, it had to offer both dyed and undyed kerosene. This “dyed-fuel mandate” was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000, and later until January 1, 2002.

²⁹³ Tax is imposed before that point if the motor fuel is transferred (other than in bulk) from a refinery or if the fuel is sold to an unregistered party while still held in the refinery or bulk distribution system (e.g., in a pipeline or terminal facility).

Reasons for Change

When the rules governing taxation of kerosene used as a highway motor fuel were enacted in 1997, the Congress was concerned that dyed kerosene and diesel fuel (destined for nontaxable uses) might be unavailable in markets where those fuels were commonly used (e.g., as heating oil). To ensure availability of untaxed, dyed fuels for those uses, the Congress included a requirement that terminals offer both dyed and undyed kerosene and diesel fuel (if they offered the fuels for sale at all) as a condition of receiving untaxed fuels. Since that time, markets have provided dyed kerosene and diesel fuel for nontaxable uses where there is a demand for them.

Explanation of Provision

The diesel fuel and kerosene dyeing mandate is repealed.

Effective Date

The provision is effective January 1, 2002.

Revenue Effect

The provision is expected to have a negligible revenue effect on Federal fiscal year budget receipts.

**PART NINE: THE CLERGY HOUSING ALLOWANCE
CLARIFICATION ACT OF 2002 (PUBLIC LAW 107-181)²⁹⁴**

Present and Prior Law

Section 107 of the Internal Revenue Code provides that a minister of the gospel's gross income does not include: (1) the rental value of a home furnished as part of his or her compensation; or (2) the rental allowance paid as part of his or her compensation, to the extent used to rent or provide a home. The Internal Revenue Service's position (Rev. Rul. 71-280, 1971-2 C.B.92) is that the amount of the section 107 rental allowance exclusion may not exceed the fair rental value of the home plus the cost of utilities.

In *Warren v. Commissioner*, 114 T.C. No. 343 (2000), appeal dismissed 302 F.3d 1012 (9th Cir. 2002), the Tax Court ruled that the section 107 rental allowance exclusion is limited to the amount used to provide the home, and not the fair rental value of the home.

Explanation of Provision

The Act clarifies that the amount of the section 107 rental allowance exclusion may not exceed the fair rental value of the home (including furnishings and appurtenances) plus the cost of utilities.

Effective Date

The provision is generally applicable for taxable years beginning after December 31, 2001. The provision also applies to taxable years beginning before January 1, 2002, for which the taxpayer: (1) filed a tax return before April 17, 2002, indicating that the section 107 rental allowance exclusion is limited to the fair rental value of the home (including furnishings and appurtenances) plus the cost of utilities; or (2) files a return after April 16, 2002. Other tax returns for taxable years beginning before January 1, 2002, are not subject to the fair rental value limitation added by the bill.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than \$500,000 annually in 2002 and 2003, \$1 million annually in 2004 and 2005, \$2 million in 2006, \$3 million in

²⁹⁴H.R. 4156. The bill was referred to the House Committee on Ways and Means. The House passed the bill on April 16, 2002, under a motion to suspend the rules and pass the bill. See Joint Committee on Taxation, *Description of H.R. 4156, The Clergy Housing Clarification Act of 2002, As Passed by the House of Representatives on April 16, 2002* (JCX-31-02), April 18, 2002. The bill was referred to the Senate Committee on Finance. The Finance Committee discharged the bill by unanimous consent. The Senate passed the bill on May 2, 2002, by unanimous consent. The President signed the bill on May 20, 2002. The bill was not reported by any Committee of the House of Representatives or the Senate. Therefore, the bill does not have any formal legislative history. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

2007, \$4 million in 2008, \$5 million annually in 2009 and 2010, \$6 million annually in 2011 and 2012.

PART TEN: REVENUE PROVISION OF THE TRADE ADJUSTMENT ASSISTANCE REFORM ACT OF 2002 (PUBLIC LAW 107-210)²⁹⁵

I. REFUNDABLE CREDIT FOR HEALTH INSURANCE COSTS OF ELIGIBLE INDIVIDUALS (Secs. 201(a), 202 and 203 of the Act and new secs. 35, 6050T, 6103(l)(18), and 7527 of the Code)

Present and Prior Law

Under present and prior law, the tax treatment of health insurance expenses depends on the individual's circumstances. In general, employer contributions to an accident or health plan are excludable from an employee's gross income (section 106).

Self-employed individuals are entitled to deduct a portion of the amount paid for health insurance expenses for the individual and his or her spouse and dependents. The percentage of deductible expenses is 70 percent in 2002 and 100 percent in 2003 and thereafter.

Individuals other than self-employed individuals who purchase their own health insurance may deduct their health insurance expenses only if they itemize deductions and only to the extent that their total unreimbursed medical expenses exceed 7.5 percent of adjusted gross income.

Prior law did not provide a tax credit for the purchase of health insurance.

The health care continuation rules (commonly referred to as "COBRA" rules, after the Consolidated Omnibus Budget Reconciliation Act of 1985 in which they were enacted) require that employer-sponsored group health plans of employers with 20 or more employees must offer certain covered employees and their dependents ("qualified beneficiaries") the option of purchasing continued health coverage in the event of loss of coverage resulting from certain qualifying events. These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, enrollment in Medicare, the bankruptcy of the employer, or

²⁹⁵ H.R. 3009. The "Trade Adjustment Assistance Reform Act of 2002" is Division A of the "Trade Act of 2002," Pub. L. No. 107-210, July 26, 2002. H.R. 3009 was reported (as amended) by the House Committee on Ways and Means on November 14, 2001 (H.R. Rep. No. 107-290) and was passed by the House on November 16, 2001. As initially passed by the House, H.R. 3009 covered Andean trade provisions. The Senate Committee on Finance reported H.R. 3009, as amended, on December 14, 2001 (S. Rep. No. 107-126). The bill as reported by the Finance Committee covered Andean trade provisions. The Senate agreed to S. Amdt. 3401 on May 23, 2002, as a substitute to H.R. 3009. This version of the bill contained broader trade provisions and a refundable health credit for eligible individuals. The House agreed to the Senate amendment, with an amendment pursuant to H. Res. 450 on June 26, 2002. Differences between the bills were resolved in conference. A conference report on the bill was filed in the House on July 26, 2002 (H.R. Rep. No. 107-624). The conference report was passed by the House on July 27, 2002, and by the Senate on August 1, 2002. H.R. 3009 was signed by the President on August 6, 2002.

the end of a child's dependency under a parent's health plan. In general, the maximum period of COBRA coverage is 18 months. A longer maximum period applies in certain cases. An employer is permitted to charge qualified beneficiaries 102 percent of the applicable premium for COBRA coverage.

Under present law, individuals without access to COBRA are able to purchase individual policies on a guaranteed issue basis without exclusion of coverage for pre-existing conditions if they had 18 months of creditable coverage under an employer sponsored group health plan, governmental plan, or a church plan. Those with access to COBRA are required to exhaust their 18 months of COBRA prior to obtaining a policy on a guaranteed issue basis without exclusion of coverage for pre-existing conditions.

Explanation of Provision

Refundable health insurance credit: in general

In the case of taxpayers who are eligible individuals, a refundable tax credit is provided for 65 percent of the taxpayer's expenses for qualified health insurance of the taxpayer and qualifying family members for each eligible coverage month beginning in the taxable year. The credit is available only with respect to amounts paid by the taxpayer.

Qualifying family members are the taxpayer's spouse and any dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency exemption.²⁹⁶ Any individual who has other specified coverage is not a qualifying family member.

Persons eligible for the credit

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if, as of the first day of the month, the taxpayer (1) is an eligible individual, (2) is covered by qualified health insurance, (3) does not have other specified coverage, and (4) is not imprisoned under Federal, State, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements. An eligible month must begin more than 90 days after the date of enactment of the Trade Act of 2002.²⁹⁷

An eligible individual is (1) an eligible TAA recipient, (2) an eligible alternative TAA recipient, and (3) an eligible PBGC pension recipient.

An individual is an eligible TAA recipient during any month if the individual (1) is receiving for any day of such month a trade adjustment allowance²⁹⁸ or who would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment benefits before being eligible to receive an allowance and (2) with respect to such allowance, is covered under a certification issued under subchapter A or D of chapter 2 of title II

²⁹⁶ Present and prior law allows the custodial parent to release the right to claim the dependency exemption for a child to the noncustodial parent. In addition, if certain requirements are met, the parents may decide by agreement that the noncustodial parent is entitled to the dependency exemption with respect to a child. In such cases, the provision treats the child as the dependent of the custodial parent for purposes of the credit.

²⁹⁷ The date of enactment is August 6, 2002.

²⁹⁸ Part I of subchapter B, or subchapter D, of chapter 2 of title II of the Trade Act of 1974.

of the Trade Act of 1974. An individual is treated as an eligible TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is an eligible alternative TAA recipient during any month if the individual (1) is a worker described in section 246(a)(3)(B) of the Trade Act of 1974 who is participating in the program established under section 246(a)(1) of such Act, and (2) is receiving a benefit for such month under section 246(a)(2) of such Act. An individual is treated as an eligible alternative TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is a PBGC pension recipient for any month if he or she (1) is age 55 or over as of the first day of the month, and (2) is receiving a benefit any portion of which is paid by the Pension Benefit Guaranty Corporation (the "PBGC").

An otherwise eligible taxpayer is not eligible for the credit for a month if, as of the first day of the month the individual has other specified coverage. Other specified coverage is (1) coverage under any insurance which constitutes medical care (except for insurance substantially all of the coverage of which is for excepted benefits)²⁹⁹ if at least 50 percent of the cost of the coverage is paid by an employer³⁰⁰ (or former employer) of the individual or his or her spouse or (2) coverage under certain governmental health programs.³⁰¹ A rule aggregating plans of the same employer applies in determining whether the employer pays at least 50 percent of the cost of coverage. A person is not an eligible individual if he or she may be claimed as a dependent on another person's tax return. A special rule applies with respect to alternative TAA recipients.

Qualified health insurance

Qualified health insurance eligible for the credit is: (1) COBRA continuation coverage; (2) State based continuation coverage provided by the State under a State law that requires such coverage; (3) coverage offered through a qualified State high risk pool; (4) coverage under a health insurance program offered to State employees or a comparable program; (5) coverage through an arrangement entered into by a State and a group health plan, an issuer of health insurance coverage, an administrator, or an employer; (6) coverage offered through a State arrangement with a private sector

²⁹⁹ Excepted benefits are: (1) coverage only for accident or disability income or any combination thereof; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) worker's compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; (7) coverage for on-site medical clinics; (8) other insurance coverage similar to the coverages in (1)–(7) specified in regulations under which benefits for medical care are secondary or incidental to other insurance benefits; (9) limited scope dental or vision benefits; (10) benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof; and (11) other benefits similar to those in (9) and (10) as specified in regulations; (12) coverage only for a specified disease or illness; (13) hospital indemnity or other fixed indemnity insurance; and (14) Medicare supplemental insurance.

³⁰⁰ An amount is considered paid by the employer if it is excludable from income. Thus, for example, amounts paid for health coverage on a salary reduction basis under an employer plan are considered paid by the employer.

³⁰¹ Specifically, an individual is not eligible for the credit if, as of the first day of the month, the individual is (1) entitled to benefits under Medicare Part A, enrolled in Medicare Part B, or enrolled in Medicaid or SCHIP, (2) enrolled in a health benefits plan under the Federal Employees Health Benefit Plan, or (3) entitled to receive benefits under chapter 55 of title 10 of the United States Code (relating to military personnel). An individual is not considered to be enrolled in Medicaid solely by reason of receiving immunizations.

health care coverage purchasing pool; (7) coverage under a State-operated health plan that does not receive any Federal financial participation; (8) coverage under a group health plan that is available through the employment of the eligible individual's spouse; and (9) coverage under individual health insurance if the eligible individual was covered under individual health insurance during the entire 30-day period that ends on the date the individual became separated from the employment which qualified the individual for the TAA allowance, the benefit for an eligible alternative TAA recipient, or a pension benefit from the PBGC, whichever applies.³⁰²

Qualified health insurance does not include any State-based coverage (i.e., coverage described in (2)–(8) in the preceding paragraph), unless the State has elected to have such coverage treated as qualified health insurance and such coverage meets certain requirements. Such State coverage must provide that each qualifying individual is guaranteed enrollment if the individual pays the premium for enrollment or provides a qualified health insurance costs eligibility certificate and pays the remainder of the premium. In addition, the State-based coverage cannot impose any pre-existing condition limitation with respect to qualifying individuals. State-based coverage cannot require a qualifying individual to pay a premium or contribution that is greater than the premium or contribution for a similarly situated individual who is not a qualified individual. Finally, benefits under the State-based coverage must be the same as (or substantially similar to) benefits provided to similarly situated individuals who are not qualifying individuals. A qualifying individual is an eligible individual who seeks to enroll in the State-based coverage and who has aggregate periods of creditable coverage³⁰³ of three months or longer, does not have other specified coverage, and who is not imprisoned. A “qualifying individual” also includes qualified family members of such an eligible individual.

Qualified health insurance does not include coverage under a flexible spending or similar arrangement or any insurance if substantially all of the coverage is of excepted benefits.

Other rules

Amounts taken into account in determining the credit may not be taken into account in determining the amount allowable under the itemized deduction for medical expenses or the deduction for health insurance expenses of self-employed individuals. Amounts distributed from a medical savings account are not eligible for the credit. The amount of the credit available through filing a tax return is reduced by any credit received on an advance basis. Married taxpayers filing separate returns are eligible for the credit; however, if both spouses are eligible individuals and the spouses file a separate return, then the spouse of the taxpayer is not a qualifying family member.

³⁰² For this purpose, “individual health insurance” means any insurance which constitutes medical care offered to individuals other than in connection with a group health plan. Such term does not include Federal- or State-based health insurance coverage.

³⁰³ Creditable coverage is determined under the Health Care Portability and Accountability Act (Code sec. 9801(c)).

The Secretary of the Treasury is authorized to prescribe such regulations and other guidance as may be necessary or appropriate to carry out the provision.

Advance payment of refundable health insurance credit; reporting requirements

The credit is payable on an advance basis (i.e., prior to the filing of the taxpayer's return) pursuant to a program to be established by the Secretary of the Treasury no later than August 1, 2003. Such program is to provide for making payments on behalf of certified individuals to providers of qualified health insurance. In order to receive the credit on an advance basis, a qualified health insurance costs credit eligibility certificate would have to be in effect for the taxpayer. A qualified health insurance costs credit eligibility certificate is a written statement that an individual is an eligible individual for purposes of the credit, provides such information as the Secretary of the Treasury may require, and is provided by the Secretary of Labor or the PBGC (as appropriate) or such other person or entity designated by the Secretary.

The disclosure of return information of certified individuals to providers of health insurance information is permitted to the extent necessary to carry out the advance payment mechanism.

Any person who receives payments during a calendar year for qualified health insurance and claims a reimbursement for an advance credit amount is required to file an information return with respect to each individual from whom such payments were received or for whom such a reimbursement is claimed. The return is to be in such form as the Secretary may prescribe and is to contain the name, address, and taxpayer identification number of the individual and any other individual on the same health insurance policy, the aggregate of the advance credit amounts provided, the number of months for which advance credit amounts are provided, and such other information as the Secretary may prescribe. Similar information must be provided to the individual no later than January 31 of the year following the year for which the information return is made.

Effective Date

The provision is generally be effective with respect to taxable years beginning after December 31, 2001. The provision relating to the advance payment mechanism to be developed by the Secretary is effective on the date of enactment.

Revenue Effect

The provision to create a new 65 percent refundable credit for the purchase of health insurance coverage by certain taxpayers eligible for TAA assistance or alternative TAA assistance is estimated to reduce Federal fiscal year budget receipts by \$122 million in 2003, \$212 million in 2004, \$260 million in 2005, \$272 million in 2006, \$285 million in 2007, \$297 million in 2008, \$309 million in

2009, \$321 million in 2010, \$333 million in 2011, and \$345 million in 2012.³⁰⁴

The provision to create a new 65 percent refundable credit for the purchase of health insurance coverage by certain PBGC pension recipients is estimated to reduce Federal fiscal year budget receipts by \$172 million in 2003, \$187 million in 2004, \$192 million in 2005, \$198 million in 2006, \$203 million in 2007, \$209 million in 2008, \$214 million in 2009, \$220 million in 2010, \$225 million in 2011, and \$231 million in 2012.³⁰⁵

³⁰⁴The estimate of the reduction in Federal fiscal year budget receipts includes the following increase in outlays: \$37 million in 2003, \$66 million in 2004, \$86 million in 2005, \$90 million in 2006, \$94 million in 2007, \$98 million in 2008, \$102 million in 2009, \$106 million in 2010, \$110 million in 2011, and \$114 million in 2012.

³⁰⁵The estimate of the reduction in Federal fiscal year budget receipts includes the following increase in outlays: \$52 million in 2003, \$58 million in 2004, \$63 million in 2005, \$65 million in 2006, \$67 million in 2007, \$69 million in 2008, \$71 million in 2009, \$73 million in 2010, \$74 million in 2011, and \$76 million in 2012.

PART ELEVEN: AN ACT RELATING TO POLITICAL ORGANIZATIONS DESCRIBED IN SECTION 527 OF THE INTERNAL REVENUE CODE (PUBLIC LAW 107-276)³⁰⁶

Present and Prior Law

In general

Section 527 provides a limited tax-exempt status to “political organizations,” meaning a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for an “exempt function.” These organizations generally are exempt from Federal income tax on their “exempt function income” (e.g., contributions they receive, membership dues, other income related to an exempt function) but are subject to tax on their net investment income and certain other income at the highest corporate income tax rate (“political organization taxable income”). Donors are exempt from gift tax on their contributions to such organizations. For purposes of section 527, the term “exempt function” means: the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.

Notice of formation as a section 527 organization

An organization is not treated as a section 527 organization unless it has given notice that it is a section 527 organization to the Secretary of the Treasury (“Secretary”).³⁰⁷ Under prior law, the notice was required to be filed electronically and in writing.

The notice is not required to be filed by: (1) any person required to report as a political committee under the Federal Election Campaign Act of 1971, (2) organizations that reasonably anticipate that their annual gross receipts always will be less than \$25,000, and (3) organizations described in section 501(c).

The notice is required to be transmitted no later than 24 hours after the date on which the organization is organized. The notice

³⁰⁶H.R. 5596. The bill was referred to the House Committee on Ways and Means. The House of Representatives considered the bill by unanimous consent and the bill was passed without objection on October 16, 2002. The Senate passed the bill without amendment by unanimous consent on October 17, 2002. The bill was signed on November 2, 2002 by the President. The bill was not reported by any Committee of the House of Representatives or the Senate. Therefore, the bill does not have any formal legislative history. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation. See Joint Committee on Taxation, *Technical Explanation of H.R. 5596, Relating to Political Organizations Described in Section 527 of the Internal Revenue Code, as Passed by the House and the Senate* (JCX-103-02), October 22, 2002.

³⁰⁷See section 527(i).

is required to include the following information: (1) the name and address of the organization and its electronic mailing address, (2) the purpose of the organization, (3) the names and addresses of the organization's officers, highly compensated employees, contact person, custodian of records, and members of the organization's Board of Directors, (4) the name and address of, and relationship to, any related entities, and (5) such other information as the Secretary may require.

The organization and the Internal Revenue Service ("IRS") are required to make the notice of status as a section 527 organization open to public inspection.³⁰⁸ In addition, the Secretary is required to make publicly available on the Internet and at the offices of the IRS a list of all political organizations that file a notice with the Secretary under section 527 and the name, address, electronic mailing address, custodian of records, and contact person for such organization.³⁰⁹ The IRS is required to make this information available within five business days after the Secretary receives a notice from a section 527 organization.

An organization that fails to file a notice with the Secretary is not treated as a section 527 organization and its exempt function income is taken into account in determining taxable income.

Disclosure of expenditures and contributors

A political organization that accepts a contribution or makes an expenditure for an exempt function during any calendar year is required to file with the Secretary certain reports.³¹⁰ The following reports are required: either (1) in the case of a calendar year in which a regularly scheduled election is held, quarterly reports, a pre-election report, and a post-general election report and, in the case of any other calendar year, a report covering January 1 to June 30 and a report covering July 1 to December 31, or (2) monthly reports for the calendar year, except that, in lieu of the reports due for November and December of any year in which a regularly scheduled general election is held, a pre-general election report, a post-general election report, and a year end report are to be filed. A political organization may choose to file pursuant to either option described above, but it must file on the same basis for the entire calendar year. An amount to be paid by the organization is imposed for a failure to file a report or to provide the required information in the report.

The reports are required to include the following information: (1) the amount of each expenditure made to a person if the aggregate amount of expenditures to such person during the calendar year equals or exceeds \$500 and the name and address of the person (in the case of an individual, including the occupation and name of the employer of the individual); and (2) the name and address (in the case of an individual, including the occupation and name of employer of such individual) of all contributors that contributed an aggregate amount of \$200 or more to the organization during the calendar year and the amount of the contribution.

³⁰⁸ Section 6104(a)(1).

³⁰⁹ Section 6104(a)(3).

³¹⁰ See section 527(j).

The disclosure requirements do not apply: (1) to any person required to report as a political committee under the Federal Election Campaign Act of 1971, (2) to any State or local committee of a political party or political committee of a State or local candidate, (3) to any organization that reasonably anticipates that it will not have gross receipts of \$25,000 or more for any taxable year, (4) to any organization described in section 501(c), or (5) with respect to any expenditure that is an independent expenditure (as defined in section 301 of the Federal Election Campaign Act of 1971).

For purposes of the disclosure requirements, the term “election” means: (1) a general, special, primary, or runoff election for a Federal office, (2) a convention or caucus of a political party that has authority to nominate a candidate for Federal office, (3) a primary election held for the selection of delegates to a national nominating convention of a political party, or (4) a primary election held for the expression of a preference for the nomination of individuals for election to the office of President.

The IRS is required to make available to the public any report filed by a political organization.³¹¹ In addition, the organization is required to make any such report available to the public for inspection at the organization’s principal office (and in certain cases, regional or district offices) during regular business hours, and provide a copy of such report upon a request made in person or in writing.³¹²

Return requirements

Under present and prior law, a section 527 organization that has political organization taxable income is required annually to file Form 1120-POL (Return for Certain Political Organizations).³¹³ Under prior law, section 527 organizations (other than organizations described in section 501(c)) that did not have political organization taxable income but had gross receipts of \$25,000 or more during the taxable year were required to file a Form 1120-POL. In addition, under prior law, the annual tax return was required to be made available to the public both by the organization and by the IRS.

Under prior law, an organization that was required to file Form 1120-POL also was required to file an annual information return, Form 990 (Return of Organization Exempt from Income Tax). Present law provides that in general, unless subject to an exception, section 527 organizations with gross receipts of \$25,000 or more for the taxable year must file an information return.³¹⁴

Under present and prior law, organizations that are required to file the annual information return are required to make the information available to the public. The IRS also must make such information public.³¹⁵

³¹¹ See section 6104(d).

³¹² *Id.*

³¹³ Section 6012(a)(6).

³¹⁴ Section 6033(g).

³¹⁵ See section 6104.

Explanation of Provision

Notice of formation and purpose (secs. 1, 6(c), (f), and (g) of the Act)

The Act provides that a political organization that is a political committee of a State or local candidate, or that is a State or local committee of a political party, is exempt from the requirement of section 527(i) to provide notice to the Secretary of its formation and purpose.

For all political organizations subject to the notice filing requirement, the Act provides that the notice be filed electronically only, thus eliminating the requirement that the notice be filed in writing as well as electronically.

In addition, the Act requires that an organization that is required to file the notice and that intends to claim exemption from the expenditure and contribution reporting requirements of section 527(j), or the information return requirements of section 6033, state such intention in the notice. If there is a material change to information provided in the notice, the organization must file a new notice not later than 30 days after the material change. An organization that fails to file a new notice is not treated as a section 527 organization and its exempt function income is taken into account in determining taxable income from the date of the material change until such time as a modified notice is filed.

Effective dates.—The provision exempting certain organizations from the filing of notice requirement and the provision regarding electronic filing are effective as if included in the amendments made by Public Law Number 106–230.

The provision requiring that an organization indicate its intent to claim a section 527(j) or section 6033 exemption is effective for notices required to be filed more than 30 days after the date of enactment.

The provision requiring filing of a modified section 527(i) notice upon a material change in information generally is effective for material changes occurring on or after the date of enactment. However, a transition rule applies in the case of material changes that occur during the 30-day period beginning on the date of enactment. In such cases, the notice is not required to be filed before the later of: (1) 30 days after the date of the material change, or (2) 45 days after the date of enactment.

Disclosure of expenditures and contributors (secs. 2, 6(e)(1), and 6(e)(2) of the Act)

Exemption for qualified State or local political organizations

The Act exempts qualified State or local political organizations from the requirement provided by section 527(j)(2) to file regular reports with the Secretary detailing contribution and expenditure information. For this purpose, a qualified State or local political organization means an organization meeting the following requirements.

First, the organization must not engage in any exempt function activities other than to influence or attempt to influence the selection, nomination, election, or appointment of any individual to any

State or local public office or office in a State or local political organization.

Second, the organization must be subject to a State law that requires the organization to report (and it so reports) information regarding each separate expenditure and contribution (including information regarding the person who makes such contribution or receives such expenditure) that otherwise would be required to be reported to the Secretary. An organization would not fail this condition solely because: (1) the minimum amount of any expenditure or contribution required to be reported under State law is not more than \$300 greater than the minimum amount required to be reported to the Secretary; (2) State law does not require the organization to report the employer or occupation of any person who makes contributions or receives expenditures, or the date of the contribution, or the date or purpose of any expenditure of the organization; or (3) the organization makes de minimis errors in complying with State law reporting requirements, so long as such errors are corrected within a reasonable period after the organization becomes aware of such errors.

Third, the State agency receiving such information must make the information public. In addition, the organization must make the information public in a manner described in section 6104(d). De minimis errors in making the information publicly available that are corrected within a reasonable period after the organization becomes aware of such errors are permitted.

Fourth, no candidate for nomination or election to Federal elective public office or individual holding such office is permitted to control or materially participate in the direction of the organization, solicit contributions to the organization (with an exception for certain de minimis contributions), or direct, in whole or in part, disbursements by the organization.

Other provisions

The Act provides that section 527(j) reports include the date and purpose (in addition to the amount) of each expenditure of \$500 or more and the date of each contribution of \$200 or more. In addition, the Act mandates electronic filing of section 527(j) reports for organizations that have, or have reason to expect, contributions or expenditures exceeding \$50,000 in a calendar year.

Effective dates.—The provision exempting qualified State or local political organizations from the section 527(j) reporting requirements is effective as if included in the amendments made by Public Law Number 106–230.

The provision requiring additional disclosures in the section 527(j) reports is effective for reports required to be filed more than 30 days after the date of enactment. The provision regarding electronic filing is effective for reports required to be filed on or after June 30, 2003.

Tax and information return requirements (sec. 3 of the Act)

The Act provides that a political organization is required to file an income tax return (Form 1120–POL) only if such organization has political organization taxable income for the taxable year. Thus, political organizations without political organization taxable

income and with gross receipts of at least \$25,000 for the taxable year are no longer required to file an income tax return. In addition, the Form 1120-POL is no longer required to be publicly available.

The Act modifies the prior law rule that an information return (Form 990) is required to be filed by organizations that are required to file an income tax return. Instead, under the Act, information returns are required for political organizations that have gross receipts of \$25,000 or more for the taxable year except that, for qualified State or local political organizations, the gross receipts threshold is \$100,000. In addition, the Act exempts the following organizations from the information return filing requirement: (1) a State or local committee of a political party, or a political committee of a State or local candidate; (2) a caucus or association of State or local officials; (3) an authorized committee (as defined in section 301(6) of the Federal Election Campaign Act of 1971) of a candidate for Federal office; (4) a national committee (as defined in section 301(14) of the Federal Election Campaign Act of 1971) of a political party; (5) a U.S. House of Representatives or U.S. Senate campaign committee of a political party committee; (6) a political committee (as defined in section 301(4) of the Federal Election Campaign Act of 1971) required to report under such Act; or (7) an organization described in section 501(c). In addition, the Act directs the Secretary to review the information return for possible modification. Also, the Secretary retains the discretion to waive the information return filing requirement.

Effective date.—The provisions regarding tax and information return requirements are effective as if included in the amendments made by Public Law Number 106–230.

Public availability of notices and reports (sec. 6(e)(3) of the Act)

Under the Act, the Secretary must make the section 527(i) notices and the electronically filed section 527(j) reports available for public inspection on the Internet not later than 48 hours of filing, and must make the entire database of such notices and reports searchable by names, States, zip codes, custodians of records, directors, and general purposes of the organization; entities related to the organization; contributors to the organization; employers of contributors; recipients of expenditures by the organization; ranges of contributions and expenditures; and time periods of the notices and reports. In addition, the database must be downloadable.

Effective date.—The provision regarding public availability of notices and reports is effective for notices and reports required to be filed on or after June 30, 2003.

Other provisions and technical corrections (secs. 4, 5, 6(a), (b), (d), and 7 of the Act)

The Act gives the Secretary the authority to waive all or any portion of the taxes imposed on an organization for failure to notify the Secretary of the organization's establishment (or to file a modified notice) or the amounts imposed for failure to file a report. Such waiver would be subject to a showing by the organization that the failure was due to reasonable cause and not to willful neglect.

The Act further provides that the Secretary in consultation with the Federal Election Commission shall publicize the effects of the Act and the interaction of the requirements to file a notification or report under section 527 and reports under the Federal Election Campaign Act of 1971.

Finally, the Act makes the following modifications. The Act clarifies that in computing taxable income for organizations that fail to notify the Secretary of their status as a political organization, all exempt function income, whether or not segregated for use for an exempt function, is taken into account. The Act also clarifies that amounts imposed for failure to report under section 527(j) are to be assessed and collected in the same manner as penalties imposed on exempt organizations for failure to file returns (section 6652(c)). The Act applies the penalty for fraudulent returns, statements, or other documents (section 7207) to the notification (section 527(i)) and reporting (section 527(j)) requirements of political organizations. In addition, the Act provides that notices and reports already made public by the Secretary may remain public, even if the retroactive effective dates of certain parts of the Act mean that a notice or report was not required to have been filed.

Effective dates.—The provision giving the Secretary the authority to waive taxes and amounts is effective for any tax assessed or amount imposed after June 30, 2000.

The remaining provisions are effective on the date of enactment.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by \$2 million in 2003, \$1 million annually in 2004 and 2005, and by less than \$500,000 in 2006 through 2012.

**PART TWELVE: THE REVENUE PROVISIONS OF THE
HOMELAND SECURITY ACT OF 2002 (PUBLIC LAW 107-
296)³¹⁶**

**A. Transfer of Certain Functions of the Bureau of Alcohol,
Tobacco and Firearms to the Department of Justice (secs.
1111 and 1112 of the Act and secs. 6103, 7801, chapter 53
and chapters 61 through 80 of the Code)**

Present and Prior Law

Except as otherwise expressly provided by law, the administration and enforcement of the Code is performed by or under the supervision of the Secretary of the Treasury (section 7801(a)). The Code imposes an excise tax on the sale of pistols, revolvers, rifles, shotguns, shells and cartridges (section 4181). The manufacturer, importer, or producer making the sale must pay the tax. Separate excise taxes are imposed on the making or transfer of “non-regular” firearms or explosive devices, as well as occupational taxes (collectively known as the “National Firearms Act”). The term “non-regular” firearm includes machine guns, explosive devices such as bombs, grenades, small rockets, and mines, sawed-off shotguns or rifles, silencers, and certain concealable weapons. In addition to the excise taxes imposed on the manufacture and transfer of non-regular firearms, present law imposes annual occupational excise taxes on importers and manufacturers (\$1,000 per year per premise) of and on dealers (\$200 per transfer) of these weapons. The Bureau of Alcohol, Tobacco, and Firearms, which under prior law was a bureau of the Department of the Treasury, administers all of these taxes in conjunction with non-tax Federal firearms laws.

The Code permits the General Accounting Office to access returns and return information for the purpose of, and to the extent necessary in making an audit of the Bureau of Alcohol, Tobacco and Firearms (section 6103(i)(8)(A)(i)).

Explanation of Provision

The Act establishes a Bureau of Alcohol, Tobacco, Firearms and Explosives within the Department of Justice and transfers certain authorities to that bureau. Among other things, this new bureau is responsible for administering the National Firearms Act (chapter 53 of the Code) and chapters 61 through 80 of the Code (regarding

³¹⁶H.R. 5005. The bill was referred to the House Committee on Ways and Means, which reported the amended bill on July 10, 2002. The House Select Committee on Homeland Security reported the bill on July 19, 2002. The House passed the bill on July 26, 2002. The Senate passed the bill with amendment on November 19, 2002. The House passed the bill with Senate amendment by unanimous consent on November 22, 2002. The President signed the bill on November 25, 2002. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

procedure and administration) to the extent such chapters relate to the enforcement and administration of the National Firearms Act. The terms “Secretary” or “Secretary of the Treasury” when applied to those chapters mean “Attorney General” and the term “internal revenue officer” when applied to those chapters means any officer of the Bureau of Alcohol, Tobacco, Firearms and Explosives so designated by the Attorney General.

With regard to certain administration and revenue collection functions, the Department of the Treasury retains the authorities, functions, personnel and assets of the Bureau of Alcohol, Tobacco, and Firearms relating to the administration and enforcement of chapters 51 and 52 of the Code (relating to taxes on distilled spirits, wines, beer, and tobacco products and cigarette papers and tubes), sections 4181 and 4182 of the Code (relating to the tax on the sale of pistols, revolvers, rifles, shotguns, shells and cartridges and exemptions) and title 27 of the United States Code. These retained functions are carried out by the Tax and Trade Bureau of the Department of the Treasury, created by the provision.

The Act makes conforming name changes to the Code to permit the General Accounting Office to access returns and return information for purposes of auditing the Tax and Trade Bureau of the Department of the Treasury and the Bureau of Alcohol, Tobacco, Firearms and Explosives of the Department of Justice as created by the provision.

Effective Date

The provision is effective sixty days after the date of enactment (sixty days after November 25, 2002, which is January 24, 2003).

Revenue Effect

The provision is estimated to have no revenue effect on Federal fiscal year budget receipts.

**PART THIRTEEN: THE REVENUE PROVISIONS OF THE
VETERANS BENEFITS IMPROVEMENT ACT OF 2002
(PUBLIC LAW 107-330)³¹⁷**

**A. Disclosure of Tax Return Information for Administration
of Certain Veterans Programs (sec. 306 of the Act and sec.
6103(l) of the Code)**

Present and Prior Law

The Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Code (section 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both (section 7213). An action for civil damages also may be brought for unauthorized disclosure (section 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 (section 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs of self-employment tax information and certain tax information supplied to the IRS and Social Security Administration by third parties. 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 (section 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to Department of Veterans Affairs.

Under prior law, the Department of Veterans Affairs disclosure provision was scheduled to expire after September 30, 2003.

Explanation of Provision

The Act extends the Department of Veterans Affairs disclosure provision through September 30, 2008.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by \$9 million in 2004, \$16 million in 2005, \$23 million in

³¹⁷S. 2237. The bill was reported by the Senate Committee on Veterans’ Affairs on June 6, 2002. The Senate passed the bill after amendment by unanimous consent on September 26, 2002. The House passed the bill with an amendment by unanimous consent on November 15, 2002. The Senate concurred to the House amendment by unanimous consent on November 18, 2002. The President signed the bill on December 6, 2002. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

2006, \$28 million in 2007, \$33 million in 2008, \$28 million in 2009, \$25 million in 2010, \$21 million in 2011 and \$19 million in 2012.

**PART FOURTEEN: THE HOLOCAUST RESTITUTION TAX
FAIRNESS ACT OF 2002 (P.L. 107-358)³¹⁸**

Present and Prior Law

Exclusion from Federal income tax for restitution received by victims of the Nazi regime

Present and prior law provides that eligible restitution payments made to an eligible individual (or the individual's heirs or estate) are: (1) excluded from gross income; and (2) not taken into account for any provision of the Code which takes into account excludable gross income in computing adjusted gross income (e.g., taxation of Social Security benefits).

The basis of any property received by an eligible individual (or the individual's heirs or estate) that is excluded under this provision is the fair market value of such property at the time of receipt by the eligible individual (or the individual's heirs or estate).

Eligible restitution payments are any payment or distribution made to an eligible individual (or the individual's heirs or estate) which: (1) is payable by reason of the individual's status as an eligible individual (including any amount payable by any foreign country, the United States, or any foreign or domestic entity or fund established by any such country or entity, any amount payable as a result of a final resolution of legal action, and any amount payable under a law providing for payments or restitution of property); (2) constitutes the direct or indirect return of, or compensation or reparation for, assets stolen or hidden, or otherwise lost to, the individual before, during, or immediately after World War II by reason of the individual's status as an eligible individual (including any proceeds of insurance under policies issued on eligible individuals by European insurance companies immediately before and during World War II); or (3) interest payable as part of any payment or distribution described in (1) or (2), above. An eligible individual is a person who was persecuted on the basis of race, religion, physical or mental disability or sexual orientation by Nazi Germany, or any other Axis regime, or any other Nazi-controlled or Nazi-allied country. Interest earned by enumerated escrow or settlement funds are also excluded under the provision.

³¹⁸H.R. 4823. The bill was referred to the House Committee on Ways and Means. See Joint Committee on Taxation, *Description of H.R. 4823, "Holocaust Restitution Tax Fairness Act of 2002"* (JCX-48-02), June 3, 2002. The House passed the bill on June 4, 2002, under a motion to suspend the rules and pass the bill. The Senate passed the bill by unanimous consent on November 20, 2002. The bill was signed by the President on December 17, 2002. The bill was not reported by any Committee of the House of Representatives or the Senate. Therefore, the bill does not have any formal legislative history. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

Sunset provision

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) made a number of changes to the Federal tax laws, including the exclusion from Federal income tax for restitution received by victims of the Nazi regime. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a “sunset” provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA’s provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 (“ERISA”) will be applied as though EGTRRA had never been enacted. Likewise, all other provisions of the Code and ERISA will be applied as though the relevant provisions of EGTRRA had never been enacted.

Explanation of Provision

The Act repeals the sunset provision of EGTRRA for purposes of the exclusion from Federal income tax for restitution received by victims of the Nazi regime.

Effective Date

The provision is effective on the date of its enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by \$3 million in 2012.

APPENDIX:
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION
ENACTED IN THE 107TH CONGRESS

APPENDIX:
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
PART ONE: FALLEN HERO SURVIVOR BENEFIT TAX FAIRNESS ACT OF 2001—Extend the Present-Law Treatment of Survivor Annuities With Respect to Public Safety Officers Killed in the Line of Duty to Payments With Respect to Individuals Dying on or Before December 31, 1996 (P.L. 107-15, signed into law by the President on June 5, 2001)														
pra 12/31/01			-4	-5	-5	-5	-5	-5	-5	-4	-4	-4	-4	-50
PART TWO: ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 (“EGTRRA”) (P.L. 107-16, signed into law by the President on June 7, 2001) ⁽¹⁾														
I. Marginal Rate Reduction Provisions (Sunset 12/31/10)														
A. Create New 10% Bracket in 2001 Through 2007 for the First \$6,000 of Taxable Income for Singles, First \$10,000 for Heads of Households, and First \$12,000 for Married Couples, and in 2008, First \$7,000 of Taxable Income for Singles, First \$10,000 for Heads of Households, and First \$14,000 for Married Couples; and Index Beginning in 2009; Credit with Advanced Payment in Lieu of Rate for 2001														
tyba 12/31/00		-38,186	-33,421	-40,223	-40,336	-40,201	-40,203	-40,065	-43,422	-45,359	-46,034	-13,871.....		-421,321

B. Reduce the Various Income Tax Rates (39.6% rate reduced to 38.6% in 2001 through 2003, 37.6% in 2004 and 2005, 35% in 2006 and thereafter; 36% rate reduced to 35% in 2001 through 2003, and 34% in 2004 and 2005, and 33% in 2006 and thereafter; 31% rate reduced to 30% in 2001 through 2003, 29% in 2004 and 2005, 28% in 2006 and thereafter; 28% rate reduced to 27% in 2001 through 2003, 26% in 2004 and 2005; and 25% in 2006 and thereafter)													
	7/1/01	-2,005	-21,100	-21,256	-29,049	-32,774	-50,924	-59,378	-60,401	-61,652	-63,033	-19,035.....	-420,607
C. Phase In Repeal of Pease Limitation of Itemized Deductions Over 5 Years													
tyba 12/31/05	.....	-1,265	-2,566	-4,003	-5,414	-7,168	-4,456.....	-24,872					
D. Phase In Repeal of the Personal Exemption Phaseout Over 5 Years													
tyba 12/31/05	.....	-473	-955	-1,382	-1,793	-2,216	-1,323.....	-8,142					
Total of Marginal Rate Reductions Provisions (Sunset 12/31/10)													
		-40,191	-54,521	-61,479	-69,385	-72,975	-92,865	-102,964	-109,208	-114,218	-118,451	-38,685.....	-874,942
II. Tax Benefits Relating to Children (Sunset 12/31/10)													
A. Increase and Expand the Child Tax Credit —increase the child tax credit from \$500 to \$600 in 2001 through 2004, \$700 in 2005 through 2008, \$800 in 2009, and \$1,000 in 2010; make refundable up to greater of 15% (10% for 2001 through 2004) of earned income in excess of \$10,000 (indexed in 2002) or present law; allow credit permanently against the AMT; repeal AMT offset of refundable credits													
tyba 12/31/00		-518	-9,291	-9,927	-10,602	-12,786	-18,320	-19,000	-19,408	-20,532	-25,200	-26,197.....	-171,781

APPENDIX—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
B. Extension and Expansion of Adoption Tax Benefits—increase the expense limit and the exclusion to \$10,000 for both non-special needs and special needs adoptions, and beginning in 2003, make the credit independent of expenses for special needs adoptions, permanently extend the credit and the exclusion, increase the phase-out start point to \$150,000, index for inflation the expenses limit and the phase-out start point for both the credit and the exclusion, and allow the credit to apply to the AMT	generally		-51	-191	-252	-293	-325	-349	-375	-403	-432	-464	-222	-3,357
	tyba 12/31/01													
C. Expansion of Dependent Care Tax Credit—increase the credit rate to 35%, increase the eligible expenses to \$3,000 for one child and \$6,000 for two or more children (not indexed), and increase the start of the phase-out to \$15,000 of AGI	tyba 12/31/02			-336	-432	-413	-393	-380	-352	-317	-296	-73	(2)	-2,992
D. Provide an Employer-Provided Child Care Credit of 25% for Child Care Expenditures and 10% for Child Care Resource and Referral Expenditures	tyba 12/31/01		-48	-108	-129	-142	-156	-169	-178	-188	-196	-90	(2)	-1,404
Total of Tax Benefits Relating to Children (Sunset 12/31/10)			-9,390	-10,562	-11,415	-13,634	-19,194	-19,898	-20,313	-21,440	-26,124	-26,824	-222	-179,534
III. Marriage Penalty Relief Provisions (Sunset 12/31/10)														
A. Standard Deduction Set at 2 Times Single for Married Filing Jointly, Phased in Over 5 Years	tyba 12/31/04					-685	-1,954	-2,580	-2,772	-3,164	-2,932	-831		-14,918

B. 15% Rate Bracket Set at 2 Times Single for Married Filing Jointly, Phased in Over 4 Years	tyba 12/31/04	-4,208	-6,204	-6,559	-5,876	-4,737	-4,001	-1,150.....	-32,735				
C. EIC Modification and Simplification)—increase in joint returns beginning and ending income level for phaseout by \$1,000 in 2002 through 2004, \$2,000 in 2005 through 2007, and \$3,000 in 2008, and indexed thereafter; simplify definition of earned income; use AGI instead of modified AGI; conform definition of qualifying child and tie-breaker rules to those in JCT simplification study; and allow math error procedure with Federal Case registry data beginning in 2004 ⁽³⁾	tyba 12/31/01	-8	-847	-1,277	-1,243	-1,817	-1,819	-1,787	-2,258	-2,240	-2,348	(2)	-15,644
Total of Marriage Penalty Relief Provisions (Sunset 12/31/10)		-8	-847	-1,277	-6,136	-9,975	-10,958	-10,435	-10,159	-9,173	-4,329	(2)	-63,297
IV. Affordable Education Provisions (Sunset 12/31/10)													
A. Education IRAs—increase the annual contribution limit to \$2,000; allow education IRA contributions for special needs beneficiaries above the age of 18; allow corporations and other entities to contribute to education IRAs; allow contributions until April 15 of the following year; allow a taxpayer to exclude Ed IRA distributions from gross income and claim the HOPE or Lifetime Learning credits as long as they are not used for the same expenses; repeal excise tax on contributions made to education IRA when contribution made by anyone on behalf of same beneficiary to a qualified tuition plan ("QTP"); modify phaseout range for married taxpayers; allow tax-free expenditures for elementary and secondary school expenses; expand the definition of qualified expenses to include certain computers and related items	tyba 12/31/01	-203	-365	-461	-561	-667	-778	-892	-1,013	-1,136	-295.....		-6,371

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
B. Qualified Tuition Plans—tax-free distributions from State plans; allow private institutions to offer prepaid tuition plans, tax-deferred in 2002, with tax-free distributions beginning in 2004; allow a taxpayer to exclude QTP distributions from gross income and claim the HOPE or Lifetime Learning credits as long as they are not used for the same expenses; expand definition of family member to include cousins; allow tax-free distributions for actual living expenses; ease rollover limitations; clarify coordination with the deduction for higher education expenses	tyba 12/31/01		-24	-53	-81	-111	-141	-170	-200	-234	-256	-64.....		-1,334
C. Employer Provided Assistance—permanently extend the exclusion for undergraduate courses and graduate level courses	cba 12/31/01		-519	-720	-760	-804	-852	-904	-958	-1,012	-1,068	-267.....		-7,864
D. Student loan interest—eliminate the 60-month rule; increase phaseout ranges to \$50,000–\$65,000 single/ \$100,000–\$130,000 joint; indexed for inflation after 2002	ipa 12/31/01		-170	-245	-262	-277	-289	-305	-321	-338	-356	-89.....		-2,652
E. Eliminate the Tax on Awards Under the National Health Corps Scholarship Program and F. Edward Hebert Armed Forces Health Professions Scholarship Program	tyba 12/31/01		-1	-1	-1	-1	-1	-1	-1	-1	-1	(2).....		-9
F. Increase Arbitrage Rebate Exception for Governmental Bonds Used to Finance Qualified School Construction from \$10 Million to \$15 Million	bia 12/31/01		(2)	-3	-5	-6	-11	-15	-16	-17	-18	-19	-17	-127

G. Issuance of Tax-Exempt Private Activity Bonds for Qualified Education Facilities With Annual State Volume Caps the Greater of \$10 Per Resident or \$5 Million	bia 12/31/01	-5	-19	-38	-61	-88	-120	-155	-191	-227	-251	-249	-1,404
H. Above-the-Line Deduction for Qualified Higher Education Expenses in 2002 Through 2005	tyba 12/31/01	-1,535	-2,063	-2,683	-2,911	-730							-9,922
Total of Affordable Education Provisions (Sunset 12/31/10)		-2,457	-3,469	-4,291	-4,732	-2,779	-2,293	-2,543	-2,806	-3,062	-985	-266	-29,683
V. Estate, Gift, and Generation-Skipping Transfer Tax Provisions (Sunset 12/31/10)													

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
<p>A. Phase In Repeal of Estate and Generation-Skipping Transfer Taxes—beginning in 2002, repeal phase out of lower rates and repeal rates in excess of 50%; in 2003, repeal rates in excess of 49%; in 2004 in excess of 48%; in 2005 in excess of 47%, in 2006 in excess of 46%, and in 2007 through 2009 in excess of 45%; reduce State death tax credit rates by 25% in 2002, 50% in 2003, 75% in 2004, and repeal in 2005; increase the unified credit to \$1 million in 2002 and 2003, \$1.5 million in 2004 and 2005, \$2 million in 2006 through 2008, and \$3.5 million in 2009; repeal section 2057 in 2004; repeal estate and generation-skipping transfer taxes in 2010; retain gift tax in 2010 and thereafter with \$1 million lifetime gift exclusion and gift tax rates set at the highest individual income tax rate; carryover basis applies to transfers at death after 12/31/09 of assets fully owned by decedents, except (1) \$1.3 million of additional basis and certain loss carryforwards of the decedent are allowed to be added to carryover basis, and (2) an additional \$3 million of basis is allowed to be added to carryover basis of assets going to surviving spouse; certain reporting requirements on bequests</p>	dda & gma 12/31/01			-6,383	-5,031	-7,054	-4,051	-9,695	-11,862	-12,701	-23,036	-53,422		-133,235

B. Expand Availability of Estate Tax Exclusion for Conservation Easements—repeal the 25-mile and 10-mile limits, and clarify the date for determining easement compliance	dda 12/31/00	-3	-19	-28	-29	-30	-32	-34	-36	-39	-42.....	-292
C. Modifications to Generation-Skipping Transfer Tax Rules												
1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips	ta 12/31/00	-1	-3	-4	-4	-4	-4	-4	-4	-4	-4.....	-36
2. Retroactive allocation of the generation-skipping tax exemption	generally 12/31/00	-1	-4	-6	-6	-6	-6	-6	-6	-6	-6.....	-53
3. Severing of trusts holding property having an inclusion ratio of greater than zero .....	.....										
4. Modification of certain valuation rules .....	.....										
5. Relief from late elections .....	.....										
6. Substantial compliance .....	.....										
D. Expand Availability of Installment Payment Relief Under Section 6166												
1. Increase from 15 to 45 the number of partners of a partnership or shareholders in a corporation eligible for installment payments of estate tax under section 6166	dda 12/31/01		-285	-297	-330	-364	-394	-383	-381	-371	-358.....	-3,163
2. Qualified lending and finance business interests	dda 12/31/01		-103	-84	-64	-43	-21	-22	-24	-25	-27.....	-413
3. Certain holding company stock	dda 12/31/01		-171	-140	-107	-72	-34	-47	-49	-42	-45.....	-707
E. Waiver of Statute of Limitations for Refunds of Recapture of Estate Tax Under Section 2032A ...	DOE	-100	-25									-125
Total of Estate, Gift, and Generation-Skipping Transfer Tax Provisions (Sunset 12/31/10) ..	.....	-105	-6,993	-5,590	-7,594	-4,570	-10,186	-12,358	-13,201	-23,523	-53,904.....	-138,024
VI. Pension and IRA Provisions (Generally Sunset 12/31/01)												
A. Individual Retirement Arrangement Provisions												

APPENDIX.—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
[Millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12	
1. Modification of IRA Contributor Limits—increase the maximum contribution limit for traditional and Roth IRAs to: \$3,000 in 2002 through 2004, \$4,000 in 2005 through 2007, and \$5,000 in 2008; index in years thereafter	tyba 12/31/01		-368	-847	-1,054	-1,693	-2,346	-2,582	-3,148	-3,817	-4,243	-3,033	-1,652	-24,784	
2. IRA Catch-Up Contributions— increase maximum contribution limits for traditional and Roth IRAs for individuals age 50 and above by \$500 in 2002 and \$1,000 in 2006	tyba 12/31/01		-69	-151	-174	-176	-225	-293	-252	-211	-234	-182	-116	-2,083	
3. Deemed IRAs under employee plans	pyba 12/31/02						<i>Negligible Revenue Effect</i>								
Total of Individual Retirement Arrangement Provisions			-437	-998	-1,228	-1,869	-2,571	-2,875	-3,400	-4,028	-4,477	-3,215	-1,768	-26,867	
B. Pension Provisions															
1. Provisions for Expanding Coverage															
a. Increase contribution and benefit limits:															
1. Increase limitation on exclusion for elective deferrals to: \$11,000 in 2002, \$12,000 in 2003, \$13,000 in 2004, \$14,000 in 2005, and \$15,000 in 2006; index thereafter ⁽⁴⁾ ⁽⁵⁾	yba 12/31/01			-100	-328	-500	-636	-708	-753	-797	-880	-436	-236	-5,374	
2. Increase limitation on SIMPLE elective contributions to: \$7,000 in 2002, \$8,000 in 2003, \$9,000 in 2004, and \$10,000 in 2005; index thereafter ⁽⁴⁾ ⁽⁵⁾	yba 12/31/01		-10	-30	-42	-51	-55	-59	-63	-66	-69	-35	-18	-498	
3. Increase defined benefit dollar limit to \$160,000	yba 12/31/01		-23	-42	-46	-47	-48	-49	-54	-57	-56	-8	(6)	-430	
4. Lower early retirement age to 62; lower normal retirement age to 65	yba 12/31/01		-3	-4	-4	-5	-5	-5	-5	-5	-5	-2	(7)	-43	

5. Increase annual addition limitation for defined contribution plans to \$40,000 with indexing in \$1,000 increments ⁽⁴⁾	yba 12/31/01	- 7	- 15	- 19	- 21	- 17	- 17	- 20	- 23	- 27	- 14	- 7	- 187
6. Increase qualified plan compensation limit to \$200,000 with indexing in \$5,000 increments ⁽⁴⁾ and expand availability of qualified plans to self-employed individuals who are exempt from the self-employment tax by reason of their religious beliefs	yba 12/31/01 & tyba 12/31/01	- 55	- 119	- 125	- 143	- 141	- 157	- 154	- 170	- 184	- 98	- 52	- 1,398
7. Increase limits on deferrals under deferred compensation plans of State and local governments and tax-exempt organizations to: \$11,000 in 2002, \$12,000 in 2003, \$13,000 in 2004, \$14,000 in 2005, and \$15,000 in 2006; index thereafter ⁽⁴⁾ ⁽⁵⁾	yba 12/31/01	- 29	- 61	- 87	- 108	- 127	- 138	- 147	- 155	- 164	- 84	- 45	- 1,145
b. Plan loans for S corporation owners, partners, and sole proprietors	yba 12/31/01	- 21	- 32	- 34	- 36	- 39	- 41	- 44	- 47	- 49	- 19	- 8	- 370
c. Modification of top-heavy rules	yba 12/31/01	- 4	- 8	- 10	- 11	- 13	- 14	- 16	- 17	- 19	- 10	- 5	- 127
d. Elective deferrals not taken into account for purposes of deduction limits	yba 12/31/01	- 47	- 88	- 103	- 111	- 119	- 127	- 135	- 144	- 152	- 103	- 50	- 1,179
e. Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations ⁽⁴⁾	yba 12/31/01	- 16	- 27	- 27	- 25	- 23	- 24	- 24	- 24	- 24	- 14	- 7	- 235
f. Definition of compensation for purposes of deduction limits ⁽⁴⁾	yba 12/31/01	- 1	- 3	- 3	- 3	- 3	- 4	- 4	- 4	- 4	- 2	- 1	- 32
g. Increase stock bonus and profit sharing plan deduction limit from 15% to 25% ⁽⁴⁾	tyba 12/31/01	- 7	- 14	- 16	- 18	- 19	- 21	- 23	- 24	- 26	- 14	- 6	- 188
h. Option to treat elective deferrals as after-tax Roth contributions	yba 12/31/05					185	236	172	90	- 5	- 358	- 365	- 45

APPENDIX.—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
[Millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
i. Nonrefundable credit to certain individuals for elective deferrals and IRA contributions (sunset 12/31/06)	tyba 12/31/01	-1,036	-2,096	-1,963	-1,856	-1,746	-920	-102	-91	-89	-86	-82	-10,067	
j. Small business (100 or fewer employees) tax credit for new retirement plan expenses—first 3 years of the plan	(8)	-3	-12	-21	-29	-29	-29	-27	-26	-25	-22	-8	-231	
k. Elimination of user fee for certain requests regarding small employer pension plans with at least one non-highly compensated employee ⁽⁹⁾	rma 12/31/01	-7	10										-17	
l. Treatment of nonresident aliens engaged in international transportation services	tyba 12/31/01	-2	-7	-7	-7	-8	-8	-8	-8	-8	-5		-68	
Total of Provisions for Expanding Coverage		-1,271	-2,668	-2,835	-2,971	-2,843	-2,085	-1,407	-1,568	-1,786	-1,310	-890	-21,634	
2. Provisions for Enhancing Fairness for Women														
a. Additional catch-up contributions for individuals age 50 and above—increase the otherwise applicable contribution limit for all plans other than SIMPLE by \$1,000 in 2002, \$2,000 in 2003, \$3,000 in 2004, \$4,000 in 2005, and \$5,000 in 2006 and thereafter, index in \$500 increments after 2006; SIMPLE plan catch-ups would be 50% of that applicable to other plans (non-discrimination rules would not apply) ⁽⁴⁾	tyba 12/31/01	-124	-243	-234	-164	-100	-84	-76	-63	-57	-38	-18	-1,201	
b. Equitable treatment for contributions of employees to defined contribution plans ⁽⁴⁾	yba 12/31/01	-45	-84	-98	-106	-113	-121	-129	-136	-144	-75	-36	-1,087	

c. Faster vesting of certain employer matching contributions	cf pyba 12/31/01																		<i>Negligible Revenue Effect</i>	
d. Modifications to the minimum distribution rules	yba 12/31/01	(²)	-1	-1	-2	-2	-2	-2	-2	-3	-3	-1	-19							
e. Clarification of tax treatment of division of section 457 plan benefits upon divorce	tdapma 12/31/01																		<i>Negligible Revenue Effect</i>	
f. Modification of safe harbor relief for hardship withdrawals from 401(k) plans	yba 12/31/01																		<i>Negligible Revenue Effect</i>	
g. Waiver of tax on nondeductible contributions for domestic and similar workers	tyba 12/31/01	(²)	(²)	-1	-2	-4	-6	-8	-10	-12	-14	-5	-62							
Total of Provisions for Enhancing Fairness for Women		-169	-328	-334	-274	-219	-213	-215	-211	-216	-130	-60	-2,369							
3. Provisions for Increasing Portability for Participants																				
a. Rollovers allowed among governmental section 457 plans, section 403(b) plans, and qualified plans	da 12/31/01	27	-4	-4	-5	-5	-5	-6	-6	-7	-43	-3	-61							
b. Rollovers of IRAs to workplace retirement plans	da 12/31/01																		<i>Negligible Revenue Effect</i>	
c. Rollovers of after-tax retirement plan contributions	dma 12/31/01																		<i>Negligible Revenue Effect</i>	
d. Waiver of 60-day rule	da 12/31/01																		<i>Negligible Revenue Effect</i>	
e. Treatment of forms of qualified plan distributions	yba 12/31/01																		<i>Negligible Revenue Effect</i>	
f. Rationalization of restrictions on distributions	da 12/31/01																		<i>Negligible Revenue Effect</i>	
g. Purchase of service credit in governmental defined benefit plans	ta 12/31/01																		<i>Negligible Revenue Effect</i>	
h. Employers may disregard rollovers for cash-out amounts	da 12/31/01																		<i>Negligible Revenue Effect</i>	
i. Minimum distribution and inclusion requirements for section 457 plans	da 12/31/01																		<i>Considered in Other Provisions</i>	
Total of Provisions for Increasing Portability for Participants		27	-4	-4	-5	-5	-5	-6	-6	-7	-43	-3	-61							
4. Provisions for Strengthening Pension Security and Enforcement																				

APPENDIX.—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
[Millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12	
a. Phase-in repeal of 160% of current liability funding limit; extend maximum deduction rule	pyba 12/31/01		-14	-20	-36	-36	-38	-38	-39	-41	-42	-22	(6)	-326	
b. Excise tax relief for sound pension funding	yba 12/31/01		-2	-3	-3	-3	-3	-3	-3	-3	-3	-3	(2)	-29	
c. Repeal 100% of compensation limit for multiemployer plans	yba 12/31/01		-2	-4	-4	-4	-4	-5	-5	-5	-5	-3	(2)	-41	
d. Modification of section 415 aggregation rules for multiemployer plans	tyba 12/31/01		-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	(2)	-10	
e. Investment of employee contributions in 401(k) plans	aiii TRA'97						<i>Negligible Revenue Effect</i>								
f. Prohibited allocations of stock in an ESOP S corporation	(10)		3	5	6	8	8	9	10	10	10	11	(11)	80	
g. Automatic rollovers of certain mandatory distributions	dma frap				-7	-29	-30	-32	-33	-33	-34	-26	-10	-234	
h. Clarification of treatment of contributions to multiemployer plans	yea DOE			-11	-19	-32	-38	-35	-30	-26	-19	-14	-3	-227	
i. Notice of significant reduction in plan benefit accruals	pateo/a DOE						<i>Negligible Revenue Effect</i>								
Total of Provisions for Strengthening Pension Security and Enforcement			-16	-34	-64	-97	-106	-105	-101	-99	-94	-58	-13	-787	
5. Provisions for Reducing Regulatory Burdens															
a. Modification of timing of plan valuations	pyba 12/31/01						<i>Negligible Revenue Effect</i>								
b. ESOP dividends may be reinvested without loss of dividend deduction	tyba 12/31/01		-20	-49	-59	-63	-66	-69	-71	-74	-77	-39	(6)	-587	
c. Repeal transition rule relating to certain highly compensated employees	pyba 12/31/01		-2	-3	-3	-3	-3	-4	-4	-4	-4	-2	(2)	-32	
d. Employees of tax-exempt entities (12)	LDOE						<i>Negligible Revenue Effect</i>								
e. Treatment of employer-provided retirement advice	yba 12/31/01						<i>Negligible Revenue Effect</i>								
f. Repeal of multiple use test ..	yba 12/31/01						<i>Considered in Other Provisions</i>								

Total of Provisions for Reducing Regulatory Burdens													
		-22	-52	-62	-66	-69	-73	-75	-78	-81	-41	(6)	-619
C. Tax Treatment of Electing Alaska Native Settlement Trusts—allow electing Alaska Native Settlement Trusts to tax income to the Trust not the beneficiaries ⁽¹³⁾													
(14)		-4	-4	-3	-3	-3	-3	-3	-4	-4	-1		-33
Total of Pension and IRA Provisions (Generally Sunset 12/31/01)													
		-1,892	-4,088	-4,530	-5,285	-5,816	-5,359	-5,207	-5,994	-6,665	-4,798	-2,734	-52,370
VII. AMT Relief—Increase Exemption by \$2,000 (Single) and \$4,000 (Joint) in 2001 through 2004; Sunset 12/31/04													
tyba 12/31/00		-178	-2,311	-3,161	-4,605	-3,646							-13,901
VIII. Other Provisions (Generally Sunset 12/31/10)													
A. Modification to Corporate Estimated Tax Requirements; Special Estimated Tax Rules for Certain 2001 and 2004 Corporate Estimated Tax Payments													
DOE		-32,921	32,921		-6,606	6,606							
B. Expansion of Authority to Postpone Certain Tax Deadlines Due to Disaster (Sunset 12/31/10)													
doa DOE		(2)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(6)
C. Exclude from Gross Income Certain Payments Made to Holocaust Survivors or Their Heirs ...													
aro/a 1/1/00			-3	-3	-3	-3	-3	-3	-3	-3	-3		-27
Total of Other Provisions (Generally Sunset 12/31/10)													
		-32,921	32,921	-3	-6,609	6,603	-3	-3	-3	-3	-3	(7)	-27
TOTAL OF PART TWO: ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001⁽¹⁵⁾ ⁽¹⁶⁾													
		-73,808	-37,763	-90,602	-107,702	-107,399	-135,202	-151,661	-160,067	-167,821	-187,001	-129,528	-3,222 -1,351,778
PART THREE: RENAME EDUCATION INDIVIDUAL RETIREMENT ACCOUNTS AS THE COVERDELL EDUCATIONAL SAVINGS ACCOUNTS (P.L. 107-22, signed into law by the President on July 26, 2001)													
DOE							<i>No Revenue Effect</i>						

APPENDIX—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
PART FOUR: REVENUE PROVISIONS OF THE RAILROAD RETIREMENT AND SURVIVORS' IMPROVEMENT ACT OF 2001 (P.L. 107-90, signed into law by the President on December 12, 2001) ⁽⁹⁾														
A. Repeal the Supplemental Annuity Tax	cyba 12/31/01		-59	-79	-81	-79	-77	-76	-75	-75	-74	-74	-74	-823
B. Reduce the Payroll Tax Rate on Railroad Employers	cyba 12/31/01		-59	-198	-329	-362	-366	-374	-379	-383	-384	-386	-390	-3,610
TOTAL OF PART FOUR: REVENUE PROVISIONS OF THE RAILROAD RETIREMENT AND SURVIVORS' IMPROVEMENT ACT OF 2001			-118	-277	-410	-441	-443	-450	-454	-458	-458	-460	-464	-4,433
PART FIVE: THE REVENUE PROVISION OF AN ACT MAKING APPROPRIATIONS FOR THE DEPARTMENTS OF LABOR, HEALTH AND HUMAN SERVICES, AND EDUCATION, AND RELATED AGENCIES FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 2002—Excise Tax on Failure to Comply with Mental Health Parity Requirements (P.L. 107-116, signed into law by the President on January 10, 2002) ⁽¹⁷⁾														
	10/1/01								<i>Negligible Effect On Excise Tax Receipts</i>					

PART SIX: SIMPLIFICATION OF REPORTING REQUIREMENTS RELATING TO HIGHER EDUCATION TUITION AND RELATED EXPENSES (P.L. 107-131, signed into law by the President on January 16, 2002)

epoaa *No Revenue Effect*

PART SEVEN: VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001 (P.L. 107-134, signed into law by the President on January 23, 2002)

I. Relief Provisions for Victims of April 19, 1995, September 11, 2001, and Anthrax Attacks

A. Provide Income Tax Relief for Victims of Terrorist Attacks; Relief Does Not Apply to Certain Amounts That Would Have Been Paid on Account of Death or Only Because of Certain Actions; \$10,000 Minimum Benefit Regardless of Income Tax Liability

tyebo/a 9/11/01 -151 -20 -171

B. Exclusion of Certain Death Benefits

tyebo/a 9/11/01 -25 -25 -60

C. Estate Tax Reduction

(18) -3 -45 -8 (7) (7) (7) (7) (7) (7) -56

D. Payments by Charitable Organizations Treated as Exempt Payments

pma/a 9/11/01 *Negligible Revenue Effect*

E. Exclusion of Certain Cancellations of Indebtedness

(19) -6 -6

II. Other Relief Provisions

A. Exclusion for Disaster Relief Payments

tyeo/a 9/11/01 *Negligible Revenue Effect*

B. Authority to Postpone Certain Deadlines and Required Actions

(20) *Negligible Revenue Effect*

C. Application of Certain Provisions to Terrorist or Military Actions

tyeo/a 9/11/01 -2 -2 -1 -1 (2) (2) (2) (2) (2) (2) (2) (2) -6

D. Clarify that the Special Deposit Rules Provided Under the Air Transportation Safety and System Stabilization Act Do Not Apply to Employment Taxes

(21) *No Revenue Effect*

E. Treatment of Certain Structured Settlement Payments

30da DOE (11) (11) (11) (11) (2) -1 -1 -1 -1 -1 -1 -6

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
[Millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
F. Personal Exemption for Certain Disability Trusts	tyebo/a 9/11/01		-3	-4	-5	-5	-6	-6	-7	-8	-8	-9	-9	-70
III. Disclosure of Tax Information in Terrorism and National Security Investigations	dmo/a DOE						<i>No Revenue Effect</i>							
IV. No Impact on Social Security Trust Funds	DOE						<i>No Revenue Effect</i>							
TOTAL OF PART SEVEN: VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001			-190	-96	-14	-6	-6	-7	-8	-9	-9	-10	-10	-365
PART EIGHT: JOB CREATION AND WORKER ASSISTANCE ACT OF 2002 (P.L. 107-147, signed into law by the President on March 9, 2002)														
I. Business Provisions ⁽²²⁾														
A. Special Depreciation Allowance for Certain Property—30% expending of the value of capital assets with MACRS lives of 20 years or less, leasehold improvements, and purchased software with one-year placed in service extension for certain property subject to a long production period; conform AMT depreciation for property eligible for the special depreciation allowance (sunset after 36 months) ⁽²³⁾	ppisa 9/10/01		-35,329	-32,378	-29,178	136	18,951	18,265	15,354	11,638	8,023	5,328	3,372	-15,817
B. 5-Year Carryback of Net Operating Losses and Waive the AMT 90% Limitation on the Allowance of Losses (including losses carried forward into tax years ending in 2001 and 2002) (sunset after 24 months)	NOLs gi tyea 12/31/00		-7,927	-6,623	4,197	2,865	1,891	1,256	840	568	388	269	191	-2,087

Total of Business Provisions		-43,256	-39,001	-24,981	3,001	20,842	19,521	16,194	12,206	8,411	5,597	3,563	-17,904
II. Tax Benefits for Area of New York City Damaged in Terrorist Attacks on September 11, 2001 ⁽²⁴⁾													
A. Expansion of Work Opportunity Tax Credit Targeted Categories to Include Certain Employees in New York City—for employers with 200 or fewer employees add individuals working in or relocated from the Liberty Zone as a targeted group eligible for a modified WOTC (40% on first 6,000; allow against AMT) (sunset 12/31/03)	wpoifwpa 12/31/01	-119	-259	-176	-52	-19	-6						-631
B. 30% Bonus Depreciation for Property Placed in Service in the Liberty Zone													
1. 30% expensing of the value of capital assets with MACRS lives of 20 years or less, leasehold improvements, and purchased software (sunset 12/31/06)	ppisa 9/11/01	-535	-490	-464	-445	-411	192	481	403	323	240	166	-542
2. Certain nonresidential real property and residential rental property (sunset 12/31/09)	ppisa 9/11/01	-87	-114	-136	-152	-154	-150	-146	-142	-11	33	33	-1,026
C. 5-Year Life for Leasehold Improvements in the Liberty Zone (sunset 12/31/06) ⁽²⁷⁾	ppisa 9/11/01	-11	-26	-45	-70	-102	-115	-101	-79	-50	-12	14	-595
D. Authorize Issuance of Tax-Exempt Private Activity Bonds for Rebuilding the Portion of New York City Damaged in the 9/11/01 Terrorist Attack—bonds capped at \$8 billion for replacement/reconstruction of office space, residential rental and public utility infrastructure to be issued within the next 3 years; exempt from AMT (sunset 12/31/04)	bia DOE	-11	-41	-90	-127	-137	-137	-137	-137	-137	-137	-137	-1,228
E. New York City Advance Refunding of Bonds Capped at \$9 Billion; Allow Over a 3-Year Window (sunset 12/31/04) ⁽²⁵⁾	bia DOE	-103	-124	-133	-125	-115	-98	-80	-64	-49	-30	-15	-937

APPENDIX—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12	
F. Increase in Section 179 Expensing by \$35,000; Only Half the Cost of Section 179 Liberty Zone Property Taken into Account When Applying the Phaseout Threshold (sunset 12/31/06)	ppisa 9/11/01		-36	-56	-37	-29	-23	20	49	31	21	14	9	-37	
G. Extension of Replacement Period to 5 Years for Certain Property Involuntarily Converted in the New York Liberty Zone on 9/11/01, and Substantially All of the Use of the Replacement Property is in New York City	(26)		-145	-199	-18	1	2	3	6	7	7	8	9	-318	
H. Interaction with Business Provisions of Title I .....	.....		563	520	470	-42	-303	-270	-228	-173	-120	-80	-52	285
Total of Tax Benefits for Area of New York City Damaged in Terrorist Attacks on September 11, 2001 .....	.....		-484	-789	-629	-1,041	-1,262	-561	-156	-154	-16	36	27	-5,029
III. Miscellaneous and Technical Provisions															
A. General Miscellaneous Provisions															
1. Allow Form 1099 to be provided electronically	DOE							<i>No Revenue Effect</i>							
2. Reverse the Supreme Court's decision in <i>Gillitz v. Commissioner</i> (relating to subchapter S corporations)	(28)		34	76	86	88	91	94	97	99	102	106	109	982	
3. Limit use of non-accrual experience method of accounting to amount to be received for the performance of qualified professional services	tyea DOE		5	56	47	29	16	8	10	12	13	15	17	228	
4. Exclusion for foster care payments to apply to payments by qualified placement agencies ...	tyba 12/31/01		-17	-29	-36	-44	-52	-61	-70	-80	-90	-101	-112	-692	

5. Temporary increase in the highest specified percentage applied to the interest rate used in determining additional required contributions to defined benefit pension plans and PBGC variable rate premiums (sunset 12/31/03)	(29)	1,953	3,979	346	-2,478	-1,316	-1,624	-1,764	-1,204	-714	-210	-30	-3,062
6. Above-the-line deduction for teacher classroom expenses capped at \$250 annually for 2002 and 2003	tyba 12/31/01	-152	-205	-52									-409
B. Technical Corrections to Previously Enacted Legislation	DOE		-1	-1	-1	-1	-1	-1	-1	(2)	(2)		-7
Total of Miscellaneous and Technical Provisions		1,823	3,876	390	-2,406	-1,262	-1,584	-1,728	-1,174	-689	-190	-16	-2,960
IV. No Impact on Social Security Trust Funds	DOE												No Revenue Effect
V. Emergency Designation	DOE												No Revenue Effect
VI. Extensions of Certain Expiring Provisions													
A. Treatment of Nonrefundable Personal Credits under the Individual Alternative Minimum Tax (sunset 12/31/03) ⁽³⁰⁾	tyba 12/31/01	-85	-444	-424									-953
B. Tax Credit for Electric Vehicles (sunset after 24 months)	ppisa 12/31/01 ⁽³¹⁾	-25	-43	-41	-34	-20	1	6	4	2	1	(11)	-149
C. Tax credit for Electricity Production from Wind, Closed-Loop Biomass, and Poultry Litter—facilities placed in service date (sunset 12/31/03)	fpisa 12/31/01	-11	-40	-72	-96	-108	-113	-115	-116	-119	-121	-97	-1,008
D. Work Opportunity Tax Credit (sunset 12/31/03)	wpoifibwa 12/31/01	-96	-227	-173	-62	-35	-21	-7					-621
E. Welfare-to-Work Tax Credit (sunset 12/31/03)	wpoifibwa 12/31/01	-30	-76	-61	-22	-12	-7	-3					-210
F. Deductions for Qualified Clean-Fuel Vehicle Property and Qualified Clean-Fuel Refueling Property (sunset after 24 months)	ppisa 12/31/01 ⁽³²⁾	-32	-116	-127	-109	-46	63	80	50	29	12	3	-192
G. Suspension of 100 Percent-of-Net-Income Limitation on Percentage Depletion for Oil and Gas from Marginal Wells (sunset 12/31/03)	tyba 12/31/01	-21	-35	-13									-68

APPENDIX—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
(Millions of dollars)

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
H. Authority to Issue Qualified Zone Academy Bonds (sunset 12/31/03)	oia DOE		(2)	-2	-7	-14	-19	-21	-21	-21	-21	-21	-21	-166
I. Temporary Increase in Limit on Cover Over of Rum Excise Tax Revenues (from \$10.50 to \$13.25 per proof gallon) to Puerto Rico and the Virgin Islands (sunset 12/31/03) ⁽⁹⁾	abiUSa 12/31/01		-65	-61	-14									-140
J. Tax on Failure to Comply with Mental Health Parity Requirements Applicable to Group Health Plans (through 12/31/03) ⁽³³⁾	pyba 12/31/00							<i>Negligible Effect on Excise Tax Receipts</i>						
K. Suspension of Section 809 Related to the Reduction in Policyholder Dividends for Mutual Life Insurance Companies (sunset 12/31/03)	tyba 12/31/00		-29	-53	-53	-26	-3	(2)						-165
L. Extension of Archer Medical Savings Accounts ("MSAs") (sunset 12/31/03)	1/1/02			(2)	-2	-2	-2	-2	-2	-2	-2	-2	-2	-17
M. Extension of Accelerated Depreciation and Employment Tax Credit for Incentives on Tribal Lands (through 12/31/04)	DOE			8	-163	-294	-108	23	79	123	100	54	7	-171
N. Extension of Exceptions under Subpart F for Active Financing Income (allow use of foreign statement of insurance reserves pursuant to guidance) (sunset 12/31/06)	tyba 12/31/01		-315	-1,490	-1,684	-1,903	-2,129	-1,520						-9,041
O. Repeal the Requirement that Terminals Selling Diesel Fuel and Kerosene Must Sell both Dyed and Undyed Fuel	1/1/02						<i>Negligible Revenue Effect</i>							
Total of Extensions of Certain Expiring Provisions			-709	-2,579	-2,834	-2,562	-2,482	-1,597	17	38	-11	-77	-110	-12,901

TOTAL OF PART EIGHT: JOB CREATION AND WORKER ASSISTANCE ACT OF 2002		-42,626	-38,493	-28,054	-3,008	15,836	15,779	14,327	10,916	7,695	5,366	3,464	-38,794
PART NINE: CLERGY HOUSING ALLOWANCE CLARIFICATION ACT OF 2002—Parsonage Allowance Exclusion (P.L. 107-181, signed into law by the President on May 20, 2002)													
generally	(11)	(11)	1	1	2	3	4	5	5	6	6	33	
tyba 12/31/01													
PART TEN: REVENUE PROVISIONS OF THE TRADE ADJUSTMENT ASSISTANCE REFORM ACT OF 2002 (P.L. 107-210, signed into law by the President on August 6, 2002)													
I. Refundable Credit for Health Insurance Cost of Eligible Individuals													
A. 65% Refundable Tax Credit for Purchase of Health Insurance Coverage by Certain Taxpayers Eligible for TAA Assistance or Alternative TAA Assistance; Eligible Health Insurance Coverage Includes Certain Employer Continuation Coverage, Certain State-Based Health Coverage, and Certain Privately Purchased Insurance ⁽³⁴⁾	(35)	-122	-212	-260	-272	-285	-297	-309	-321	-333	-345	-2,757	
B. 65% Refundable Tax Credit for Purchase of Health Insurance Coverage by Certain PBGC Pension Recipients ⁽³⁶⁾	(35)	-172	-187	-192	-198	-203	-209	-214	-220	-225	-231	-2,051	
TOTAL OF PART TEN: REVENUE PROVISIONS OF THE TRADE ADJUSTMENT ASSISTANCE REFORM ACT OF 2002		-294	-399	-452	-470	-488	-506	-523	-541	-558	-576	-4,808	
PART ELEVEN: MODIFY THE RULES APPLICABLE TO POLITICAL ORGANIZATIONS DESCRIBED IN SECTION 527 OF THE INTERNAL REVENUE CODE (P.L. 107-276, signed into law by the President on November 2, 2002)	(37)	-2	-1	-1	(2)	(2)	(2)	(2)	(2)	(2)	(2)	-7	

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS
Fiscal Years 2001–2012
[Millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
PART TWELVE: REVENUE PROVISIONS OF THE HOMELAND SECURITY ACT OF 2002—Transfer of the Bureau of Alcohol, Tobacco, and Firearms to the Department of Justice⁽⁹⁾ (P.L. 107-296, signed into law by the President on November 25, 2002) ...														
60da 11/25/02							<i>No Revenue Effect</i>							
PART THIRTEEN: REVENUE PROVISIONS OF THE VETERANS BENEFITS ACT OF 2002—Extend Disclosure of Tax Return Information for Administration of Certain Veterans Programs through 9/30/08⁽⁹⁾ (P.L. 107-330, signed into law by the President on December 6, 2002)														
DOE					9	16	23	28	33	28	25	21	19	202
PART FOURTEEN: HOLOCAUST RESTITUTION TAX FAIRNESS ACT OF 2002—Make Permanent The Exclusion from Gross Income Certain Payments Made to Holocaust Survivors or Their Heirs (P.L. 107-358, signed into law by the President on December 17, 2002)														
aor/a 1/1/11													-3	-3

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

Legend for "Effective" column:

abiUSa = articles brought into the United States after
 aiii TRA'97 = as if included in the Taxpayer Relief Act of 1997
 aro/a = amounts received on or after
 bia = bonds issued after
 cba = courses beginning after
 cf = contributions for
 cyba = calendar years beginning after
 da = distributions after
 dda = decedents dying after
 doa = disasters occurring after
 dma = distributions made after
 dmo/a = disclosures made on or after
 DOE = date of enactment
 epoa = expenses paid or assessed after

fpisa = facilities placed in service after
 frap = Federal regulations are prescribed
 gi = generated in
 gma = gifts made after
 ipa = interest paid after
 NOLs = net operating losses
 oia = obligations issued after
 pateo/a = plan amendments taking effect on or after
 pmo/a = payments made on or after
 ppisa = property placed in service after
 pra = payments received after
 pyba = plan years beginning after
 rma = requests made after
 ta = transfers after

tdapma = transfers, distributions, and payments made after
 tyba = taxable years beginning after
 tyea = taxable years ending after
 tyebo/a = taxable years ending before, on, or after
 tyeo/a = taxable years ending on or after
 wpoifbwa = wages paid or incurred for individuals beginning work after
 wpoifwpa = wages paid or incurred for work performed after
 yba = years beginning after
 yea = years endings after
 30da = 30 days after
 60da = 60 days after.

¹ The estimates presented in this table include the effects of certain behavioral responses to the tax proposals, including shifts between nontaxable and taxable sources of income, changes in amounts of charitable giving, and changes in the timing of realization of some sources of income. While the estimates do not include the effects of these proposals on economic growth, the proposals are likely to result in modest increases in growth of the economy during the 10-year budget estimating period. The largest component of the proposals, the marginal rate cuts, will provide incentives for more work, investment, and savings.

² Loss of less than \$500,000.

³ Estimate assumes that any constitution challenge based on the use of Federal Case registry data would not be successful.

⁴ Provision includes interaction with other provisions in Provisions for Expanding Coverage.

⁵ Provision includes interaction with the Individual Retirement Arrangement Provisions.

⁶ Loss of less than \$5 million.

⁷ Loss of less than \$1 million.

⁸ Effective for costs paid or incurred in taxable years beginning after December 31, 2001, with respect to qualified employer plans established after such date.

⁹ Estimate provided by the Congressional Budget Office.

¹⁰ Generally effective with respect to years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the proposal would be effective with respect to plan years ending after March 14, 2001.

¹¹ Gain of less than \$500,000.

¹² Directs the Secretary of the Treasury to modify rules through regulations.

¹³ Special Federal income tax rules would apply if the Trust makes an election for its first taxable year ending after the date of enactment.

¹⁴ Effective for taxable years of electing Settlement Trusts ending after the date of enactment, and to contributions made to such trust made after the date of enactment.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001-12
¹⁵ Includes the following effect on fiscal year outlays (millions)		6,226	6,600	7,006	7,081	9,597	9,542	9,360	9,668	11,080	12,244	(³⁸)	88,404

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001-12
¹⁶ Taxpayers affected by the AMT: Present Law (millions of taxpayers):	1.5	3.5	4.3	5.6	7.1	8.7	10.5	12.8	14.9	17.5	20.7	24.0	
Taxpayers affected by the AMT: Proposal (millions of taxpayers):	1.4	2.7	3.3	5.3	13.0	19.6	23.9	29.1	32.1	35.5	20.7	24.0	

¹⁷ This provision will have a negligible effect on revenues from penalty excise taxes.

¹⁸ Effective for decedents dying on or after September 11, 2001, or, in the case of victims of the Oklahoma City terrorist attack, decedents dying on or after April 19, 1995.

[Footnotes for the Appendix are continued on the following page]

Footnotes for the Appendix continued:

- ¹⁹ Effective for discharges made on or after September 11, 2001, and before January 1, 2002.
- ²⁰ Effective for disasters and terrorist or military actions occurring on or after September 11, 2001, with respect to any action of the Secretary of the Treasury, the Secretary of Labor, or the Pension Benefit Guaranty Corporation occurring on or after the date of enactment.
- ²¹ Effective as if included in section 301 of the Air Transportation Safety and System Stabilization Act.
- ²² There are interactions among the business tax provisions that can affect the revenue estimates of specific provisions. These interactions are substantial in the case of the two expensing provisions and the net operating loss provisions. For the presentation here, the provisions are assumed to be added in the order presented. So, for example, the section 179 expensing provision and the net operating loss provision assume that the special 30% depreciation provision is already in place.
- ²³ A binding contract placed-in-service extension would apply in certain cases.
- ²⁴ The New York City Liberty Zone is defined as all business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, NY.
- ²⁵ Applies to original bonds issued by New York City (governmental obligations only), New York Municipal Water Authority, and the Metropolitan Transit Authority of the State of New York (governmental obligations only), and qualified 501(c)(3) for hospital facilities in New York City.
- ²⁶ Effective for involuntary conversions in the New York Liberty Zone as a result of the terrorist attacks that occurred on September 11, 2001.
- ²⁷ Leasehold improvements that are recovered over a 5-year life are not eligible for bonus depreciation.
- ²⁸ The provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.
- ²⁹ Effective with respect to plan contributions and PBGC variable rate premiums for plan years beginning after December 31, 2001, and before January 1, 2004.
- ³⁰ The "Economic Growth and Tax Relief Reconciliation Act of 2001" provides that the child tax credit and adoption tax credit are allowed for purposes of the alternative minimum tax for 2002 through 2010.
- ³¹ The credit phases down for vehicles placed in service after 12/31/03. The credit for vehicles is reduced by 25 percent in 2004, 50 percent in 2005, and 75 percent in 2006. No credit is available after 2006.
- ³² The deduction phases down for vehicles placed in service after 12/31/03. The deductible amount for vehicles is reduced by 25 percent in 2004, 50 percent in 2005, and 75 percent in 2006. No expensing is available after 2006.
- ³³ This provision will have a negligible effect on revenues from excise taxes. The Congressional Budget Office estimates that the provision would have indirect effects on income and payroll tax revenues. CBO estimates that these revenues would decline by \$30 million in 2003 and \$10 million in 2004.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
³⁴ Estimate includes the following increase in outlays			37	66	86	90	94	98	102	106	110	114	910
³⁵ The credit would be available for eligible health insurance premiums coverage beginning 90 days after the date of enactment.													

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2001–12
³⁶ Estimate includes the following increase in outlays			52	58	63	65	67	69	71	73	74	76	677

- ³⁷ The parts of the bill relating to the exemption of certain political organizations from the notice, reporting, and return requirements are effective as if included in the amendments made by P.L. 106-230. The rest of the bill is effective on various dates.
- ³⁸ Outlays of less than \$500,000.