

**DESCRIPTION AND ANALYSIS OF
CERTAIN FEDERAL TAX PROVISIONS
EXPIRING IN 2005 AND 2006**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on March 16, 2005

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



March 11, 2005
JCX-12-05

CONTENTS

	<u>Page</u>
INTRODUCTION	1
SUMMARY LISTING OF CERTAIN FEDERAL TAX PROVISIONS EXPIRING IN 2005 AND 2006.....	2
I. PROVISIONS RELATING TO INDIVIDUAL TAXPAYERS	4
A. Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit.....	4
B. Above-the-Line Deduction for Certain Expenses of Elementary and Secondary School Teachers.....	6
C. Deduction of State and Local General Sales Taxes	9
D. Archer Medical Savings Accounts.....	11
E. Above-the-Line Deduction for Certain Higher Education Expenses	16
II. PROVISIONS RELATING TO BUSINESS TAXPAYERS	20
A. Investment and Employment	20
1. Research and experimentation (R&E) tax credit	20
2. Work opportunity tax credit.....	34
3. Welfare-to-Work tax credit.....	40
4. Indian employment tax credit	42
5. Accelerated depreciation for business property on an Indian Reservation.....	44
6. 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant improvements.....	46
B. Energy and Environment	51
1. Credit for electricity produced from certain renewable resources.....	51
2. Expensing of brownfields remediation costs	60
3. Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells	63
C. Miscellaneous	67
1. Deduction for corporate donations of computer technology	67
2. Parity in the application of certain limits to mental health benefits	70
III. PROVISIONS RELATING TO STATE AND LOCAL GOVERNMENTS	73
A. District of Columbia	73
1. Tax Incentives for investment in the District of Columbia.....	73
2. District of Columbia Homebuyer Tax Credit	77
B. New York Liberty Zone.....	80
1. New York Liberty Zone advance refundings.....	80
2. Tax incentives for investment in the New York Liberty Zone	82
C. Qualified Zone Academy Bonds.....	89

IV. PROVISIONS RELATING TO TAX ADMINISTRATION.....	94
A. Disclosure of Tax Information to Facilitate Combined Employment Tax Reporting.....	94
B. Disclosure of Return Information Regarding Terrorist Activities.....	96
C. Disclosure of Return Information to Carry Out Income Contingent Repayment of Student Loans	101
D. Authority for Undercover Operations.....	106
E. Joint Review of IRS Strategic Plans and Budget.....	108

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 16, 2005, on certain Federal tax provisions expiring in 2005 and 2006. This document,¹ prepared by the staff of the Joint Committee on Taxation, includes a description and analysis of these provisions.

In general, this document discusses tax provisions expiring in 2005, except those relating to the following areas: (1) individual income tax provisions under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA”), except those expiring in 2005; (2) provisions relating to retirement plans and retirement savings; (3) provisions relating to transportation; and (4) provisions relating to Puerto Rico. In addition, this document discusses tax provisions expiring in 2006 that relate to tax incentives for investment in the New York Liberty Zone.

This document begins with a summary listing of the provisions discussed in this document. Following the summary listing, Parts I through IV of this document describe in detail the relevant Federal tax provisions relating to individual taxpayers, business taxpayers, State and local governments, and tax administration, respectively.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Certain Federal Tax Provisions Expiring in 2005 and 2006* (JCX-12-05), March 11, 2005.

SUMMARY LISTING OF CERTAIN FEDERAL TAX PROVISIONS EXPIRING IN 2005 AND 2006

The following is a summary listing of the tax provisions expiring in 2005 and 2006 that are the subject of this document (with the applicable expiration date and section of the Internal Revenue Code).

Provisions relating to individual taxpayers

- Election to include combat pay as earned income for purposes of the earned income credit (December 31, 2005; sec. 32(c)(2)(B)(vi))
- Above-the-line deduction for certain expenses of elementary and secondary school teachers (December 31, 2005; sec. 62(a)(2)(D))
- Deduction of State and local general sales taxes (December 31, 2005; sec. 164(b)(5))
- Archer medical savings accounts (“MSAs”) (December 31, 2005; sec. 220(i))
- Above-the-line deduction for certain higher education expenses (December 31, 2005; sec. 222(e))

Provisions relating to business taxpayers

Investment and employment

- Research and experimentation (R&E) tax credit (December 31, 2005; sec. 41(h))
- Work opportunity tax credit (December 31, 2005; sec. 51(c)(4))
- Welfare-to-work tax credit (December 31, 2005; sec. 51A(f))
- Indian employment tax credit (December 31, 2005; sec. 45A(f))
- Accelerated depreciation for business property on an Indian reservation (December 31, 2005; sec. 168(j)(8))
- 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant improvements (December 31, 2005; sec. 168(e)(3)(E)(iv) and (v))

Energy and environment

- Credit for electricity produced from certain renewable resources (December 31, 2005; sec. 45(d)(1)-(7))
- Expensing of “brownfields” remediation costs (December 31, 2005; sec. 198(h))
- Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells (December 31, 2005; sec. 613A(c)(6)(H))

Miscellaneous

- Deduction for corporate donations of computer technology (December 31, 2005; sec. 170(e)(6)(G))
- Parity in the application of certain limits to mental health benefits (December 31, 2005; sec. 9812(f))

Provisions relating to State or local governments

District of Columbia

- Incentives for investment in the District of Columbia: designation of enterprise zone, employment tax credit, additional expensing, empowerment zone bonds, and zero-percent capital gains rate (December 31, 2005; secs. 1400(f)(1), 1400A(b), and 1400B(b)(2), (3)(A), (4)(A)(i), and (4)(B)(i)(I))
- Tax credit for first-time D.C. homebuyers (December 31, 2005; sec. 1400C(i))

New York Liberty Zone

- Advance refunding of certain tax-exempt bonds (December 31, 2005; sec. 1400L(e)(1))
- Incentives for investment in the New York Liberty Zone: special depreciation allowance, five-year recovery period for certain leasehold improvements, increase in expensing under section 179, and extension of replacement period for nonrecognition of gain (December 31, 2006; secs. 1400L(b)(2)(A)(v), (c)(2)(B), (f)(2), and (g))

Qualified zone academy bonds

- Bond authority (December 31, 2005; sec. 1397E(e)(1))

Provisions relating to tax administration

- Disclosure of tax information to facilitate combined employment tax reporting (December 31, 2005; sec. 6103(d)(5))
- Disclosure of return information regarding terrorist activities (December 31, 2005; sec. 6103(i)(3)(C)(iv) and (i)(7)(E))
- Disclosure of return information to carry out income contingent repayment of student loans (December 31, 2005; sec. 6103(l)(13)(D))
- Authority for undercover operations (December 31, 2005; sec. 7608(c)(6))
- Joint Committee on Taxation report and joint review of IRS strategic plans (June 1, 2005, and December 31, 2005; secs. 8021(f)(2) and 8022(3)(C))

I. PROVISIONS RELATING TO INDIVIDUAL TAXPAYERS

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

Present Law

Child credit

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

Earned income credit

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after the date of enactment and before January 1, 2006.

Legislative History

The taxpayer election to treat combat pay as earned income for purposes of the earned income credit was enacted in the Working Families Tax Relief Act of 2004.

President's Budget Proposal

The proposal extends the provision relating to the earned income credit for one year (through December 31, 2006).

Analysis

The exclusion of combat pay from gross income is intended to benefit military personnel serving in combat. However, to the extent that certain tax benefits, such as the child credit and the earned income credit, may vary based on taxable or earned income, the exclusion has the potential to increase tax liability. Including combat pay in gross income for purposes of the refundable child credit is always advantageous to the taxpayer. However, including combat pay for purposes of calculating the earned income credit may either help or hurt the taxpayer, because the credit both phases in and phases out based on earned income.²

If the objective of the present-law rules is to ensure that the exclusion of combat pay from gross income does not result in an increase in tax liability, an election to include combat pay in income for all Code purposes would be sufficient to achieve that objective. Present law,

² A similar issue would arise with respect to the child credit, because that credit also is phased out based on adjusted gross income. However, present law addresses this potential adverse effect by including combat pay only for purposes of calculating the refundable portion of the credit.

however, takes a more taxpayer favorable approach by allowing the tax treatment of combat pay to vary across Code provisions when such variation is favorable, and thus present law (1) always treats combat pay as earned income for purposes of the refundable portion of the child credit, as that is always the most favorable result because the refundable child credit can only rise as income rises, and (2) allows the taxpayer to elect to include combat pay as earned income for purposes of the EIC (advantageous to the taxpayer depending on the amount of earned income that would result).

The election to include or exclude combat pay for purposes of the earned income credit creates complexity. In general, elections always add complexity, because taxpayers need to calculate their tax liability in more than one way in order to determine which result is best for them.

The present-law rules with respect to combat pay treat such pay differently than other nontaxable compensation for purposes of the definition of earned income in the refundable child credit and the earned income credit. For example, under present law, other nontaxable employee compensation (e.g., elective deferrals such as salary reduction contributions to 401(k) plans) is not includible in earned income for these purposes. Allowing combat pay to be included in earned income creates an inconsistent treatment between it and other nontaxable employee compensation and arguably creates inequities between taxpayers who receive combat pay compared to other types of nontaxable compensation.

B. Above-the-Line Deduction for Certain Expenses of Elementary and Secondary School Teachers

Present Law

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses 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 \$145,950 (for 2005). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2006, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. 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.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2005.

Legislative History

The deduction for certain expenses of elementary and secondary teachers was established in the Job Creation and Worker Assistance Act of 2002.³ The deduction was allowed only for taxable years beginning during 2002 and 2003. The deduction was extended in the Working Families Tax Relief Act of 2004⁴ to include taxable years beginning in 2004 and 2005.

³ Pub. Law. No 107-147. sec. 406.

⁴ Pub. Law. No 108-311. sec. 307.

President's Budget Proposal

The current-law provision would be made permanent and the maximum deduction increased to \$400. As under current law, the provision would apply to teachers and other school personnel employed by public entities, charter schools or private schools (as determined under state law). The current-law 900-hour rule would be clarified to refer to a school year ending during the taxable year. Eligible, unreimbursed expenses would be expanded to include teacher training expenses related to current teaching positions. Neither travel nor lodging expenses nor expenditures related to religious instruction or activities would be eligible. Expenses claimed as an above-the-line deduction could not be claimed as an itemized deduction or taken into account in determining any other tax benefit such as Hope or lifetime learning credits. Taxpayers would be required to retain receipts for eligible expenditures along with a certification from a principal or other school official that the expenditures qualified. The proposal would be effective for expenses incurred in taxable years beginning after December 31, 2005.

Analysis

Policy issues

The section 62 above-the-line deduction attempts to make fully deductible many of the legitimate business expenses of eligible schoolteachers. As described below, and absent an above-the-line deduction, the expenses might otherwise be deductible except for the two-percent floor that applies to miscellaneous itemized deductions. Some have observed that the two-percent floor increases pressure to enact above-the-line deductions on an expense-by-expense basis. In addition to increasing complexity, the expense-by-expense approach is not fair to other taxpayers with legitimate business expenses that remain subject to the two-percent floor. For example, emergency response professionals incur similar unreimbursed expenses related to their employment, a deduction for which also has been separately proposed.⁵

The President's budget proposal expands the present-law above-the-line deduction for eligible educators by increasing the maximum deduction from \$250 to \$400, thereby making additional legitimate business expenses deductible. As is the case with the present-law above-the-line deduction, the proposal presents compliance issues. One reason the two-percent floor was introduced was to reduce the administrative burden on the IRS to monitor compliance with small deductions. Some argue that any proposal that circumvents the two-percent floor will encourage tax evasion. Others argue that although tax evasion is a risk, the risk is the same for similarly situated taxpayers (e.g., independent contractors or taxpayers with trade or business income) who are not subject to the two-percent floor on similar expenses.

Complexity issues

Three provisions of present law restrict the ability of teachers to deduct as itemized deductions those expenses covered by the President's budget proposal: (1) the two-percent floor

⁵ See the conference report to H.R. 1836, the "Economic Growth and Tax Relief Reconciliation Act of 2001," H. Rep. No. 107-84, at 169-70 (2001).

on itemized deductions; (2) the overall limitation on itemized deductions; and (3) the alternative minimum tax. The staff of the Joint Committee on Taxation has previously identified these provisions as sources of complexity and has recommended that such provisions be repealed.⁶ These provisions do not apply to eligible expenses under the proposal. While repealing these provisions for all taxpayers reduces the complexity of the Federal tax laws, effectively repealing these provisions only for certain taxpayers (such as teachers and other eligible educators) likely increases complexity.

Some may view the above-the-line deduction as increasing simplification by providing for deductibility of certain expenses without regard to the present-law restrictions applicable to itemized deductions and the alternative minimum tax. However, several elements of the above-the-line deduction increase complexity. The above-the-line deduction may increase recordkeeping requirements for certain taxpayers. Taxpayers wishing to take advantage of the above-the-line deduction are required to keep records, even if they were not otherwise required to do so because their expenses were not deductible as a result of the 2-percent floor for itemized deductions. In general, enactment of additional above-the-line deductions for specific expenses undermines the concept of the standard deduction, which exists in part to simplify the tax code by eliminating the need for many taxpayers to keep track of specific expenses.

The above-the-line deduction does not completely eliminate the need to apply the present-law rules regarding itemized deductions. For example, a teacher with expenses in excess of the \$250 cap or with other miscellaneous itemized deductions may need to compute tax liability under the itemized deduction rules as well as under the above-the-line deduction rules. In addition, the above-the-line deduction does not cover all classroom expenses, but only those that meet particular requirements. Expenses that do not meet those requirements remain subject to the itemized deduction rules. Similarly, under the President's budget proposal, some expenses may either be deductible or used for tax benefits under other provisions. For example, certain teacher education expenses may be deductible under the proposal or used for a Hope or Lifetime Learning credit. Taxpayers with such expenses need to determine tax liability in more than one way in order to determine which provisions result in the lowest tax liability. In addition, overlapping provisions increase the likelihood that some taxpayers inadvertently claim more than one tax benefit with respect to the same expense.

⁶ See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 15, 88, 118 (JCS-3-01), April 2001.

C. Deduction of State and Local General Sales Taxes

Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004 and 2005, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.⁷ Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account filing status, number of dependents, adjusted gross income and rates of State and local general sales taxation. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

The term "general sales tax" means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complimentary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

⁷ A technical correction may be needed so that the statute reflects this intent. See section 2(a)(8) of H.R. 5395 and S. 3019 in the 108th Congress.

Legislative History

Prior to the Tax Reform Act of 1986, taxpayers were permitted a deduction for State and local general sales taxes. The Tax Reform Act of 1986 eliminated that deduction. The American Jobs Creation Act of 2004 added the present-law provision.⁸

President's Budget Proposal

No proposal.

Analysis

State and local governments rely on a variety of taxes to finance expenditures. The primary sources of revenue for such governments are income taxes, sales taxes, and real property taxes. The present-law deduction reflects concerns that, because not all States rely on income taxes as a primary source of revenue, allowing a deduction for State and local income taxes, but not sales taxes, may create inequities across States and may also create biases in the types of taxes that States and localities chose to impose.

Extending the option to deduct State and local general sales taxes in lieu of income taxes would cause the Federal tax laws to have a more neutral effect on the types of taxes that State and local governments utilize. Additionally, some argue that the deduction for the State and local income taxes is proper on the ground that such expense is directly related to the production of income, and, in general, expenses related to producing income are deductible. Liability for State and local sales taxes, on the other hand, is not directly related to the production of income, but rather stems from consumption expenditures. Thus, a deduction for State and local sales taxes is arguably a subsidy for consumption. It should be noted, however, that a deduction is permitted for State and local personal and real property taxes, which are unrelated to the production of income.

The election to deduct state and local sales taxes in lieu of income taxes does not eliminate inequities across states, as many States rely on both income and sales taxes, to varying degrees. Taxpayers of States that rely heavily on either the income or the sales tax would thus in general be permitted greater deductions than taxpayers of a State that relied equally on the sales and income tax. If the purpose of the deduction for State and local taxes is to reflect ability to pay, it would be better to permit the deduction for State and local sales taxes in addition to, rather than in lieu of, the deduction for State and local income taxes. Alternatively, if State and local taxes are viewed as the cost of the consumption of public goods and services, and the magnitude of such taxes reflects local preferences for consumption of public rather than private goods and services, many argue that no deduction is justified for State and local taxes, as the deduction creates a bias in favor of public over private provision of goods and services.

⁸ Pub. Law 108-357 Sec. 501.

D. Archer Medical Savings Accounts

Present Law

Archer medical savings accounts

In general

Within limits, contributions to an Archer medical savings account (“Archer 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 includible in gross income. Distributions not used for medical expenses are includible in gross income. 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.⁹ 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 he or she is 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 \$1,750 and no more than \$2,650 in the case of individual coverage and at least \$3,500 and no more than

⁹ Self-employed individuals include more than two-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

\$5,250 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 \$3,500 in the case of individual coverage and no more than \$6,450 in the case of family coverage.¹⁰ 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 certain permitted coverage. 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.

Cap on taxpayers utilizing Archer MSAs and expiration of pilot program

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2005, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously made (or had made on their behalf) Archer MSA contributions and employees who are employed by a participating employer.

Trustees of Archer MSAs are generally required to make reports to the Treasury by August 1 regarding Archer MSAs established by July 1 of that year. If any year is a cut-off year, the Secretary is required to make and publish such determination by October 1 of such year.¹¹ Based on the number of returns filed for 2003 and the projected number filed for 2004, the IRS determined that February 1, 2005, is not a cut-off date for the MSA pilot project.¹²

Health savings accounts

Health savings accounts (“HSAs”) were enacted by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.¹³ As discussed in more detail below, like Archer MSAs, an HSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. HSAs provide tax benefits similar to, but more favorable than, those provide by Archer MSA. HSAs were established on a permanent basis.

¹⁰ These dollar amounts are for 2005. These amounts are indexed for inflation, rounded to the nearest \$50.

¹¹ The reports required by MSA trustees for 2004 were treated as timely if made within 90 days after October 4, 2004. In addition, the determination of whether 2004 is a cut-off year and the publication of such determination was to be made within 120 days of October 4, 2004. If 2004 was a cut-off year, the cut-off date would be the last day of the 120-day period.

¹² Announcement 2005-12.

¹³ Pub. L. No. 108-173.

Legislative History

MSAs were added to the Code effective for taxable years beginning after December 31, 1996, by Public Law 104-191, the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”). MSAs were established on a temporary basis, as a four-year pilot program. As originally enacted, no new contributions could be made to an MSA after December 31, 2000. During the original pilot period of 1997 through 2000, the Department of the Treasury was to evaluate MSA participation and the reduction in Federal revenues due to such participation and report to the Congress as appropriate.¹⁴ The General Accounting Office (now named the Government Accountability Office) was also directed to contract with an organization experienced in health economics, health insurance markets and actuarial science to conduct a study on the effectiveness of MSAs in the small group market and report to Congress by January 1, 1999. The study was to measure the impact of MSAs on the broader health care market and to evaluate the impact of MSAs on individuals and families experiencing high health care costs.

The first phase of the study was included in a report submitted to Congress on December 19, 1997.¹⁵ The study found that the insurance industry responded rapidly by offering qualifying products, but that consumer demand was lower than anticipated. The final report of the MSA study was submitted to Congress on December 31, 1998.¹⁶ The information in the final report was only from insurers, as the report noted that the low enrollment in MSAs made it impossible to conduct useful surveys of enrollees, employers, or financial institutions at a reasonable cost. The final report echoed the first report that consumer demand had been lower than expected. The total count against the June 30, 1998, enrollment cap of 750,000 MSAs was less than 40,000.

MSAs were extended through December 31, 2002, by Public Law 106-554, the Consolidated Appropriations Act of 2002, which enacted H.R. 5662 by reference. Public Law 106-554 also changed the name of MSAs to Archer MSAs. Archer MSAs were extended through December 31, 2003, by Public Law 107-147, the Job Creation and Worker Assistance Act of 2002. Archer MSAs were extended through December 31, 2005, by Public Law 108-311, the Working Families Tax Relief Act of 2004.

Notwithstanding the extensions of Archer MSAs, no new contributions would be allowed to an Archer MSA if it was determined that the threshold level was exceeded.

President’s Budget Proposal

No proposal.

¹⁴ H.R. Conf. Rep. No. 104-736.

¹⁵ *Medical Savings Accounts: Findings from Insurer Survey* (GAO/HEHS-98-57, Dec. 19, 1997).

¹⁶ *Medical Savings Accounts: Results from Surveys of Insurers* (GAO/HEHS-99-34, Dec. 31, 1998).

Analysis

MSAs were enacted to provide additional health options and to give individuals more control over their health care dollars by providing incentives for individuals to be more cost conscious of health care.¹⁷ The Congress believed that individuals should be encouraged to save for future medical care expenses and that individuals should be allowed to save for such expenses on a tax-favored basis. The Congress believed that consumers who spend their own savings on health care will make cost-conscious decisions, thus reducing the rising cost of health care.

MSAs were established for a four-year pilot period (1997-2000), but have been extended three times. There has been debate whether Archer MSAs have been successful as the number of Archer MSAs is considerably less than the maximum threshold level of 750,000. The IRS determined that the number of Archer MSA returns filed for 2003 was 79,235.¹⁸ Of this total, 18,403 were for taxpayers reported as previously uninsured.¹⁹ The IRS also determined that 4,062 taxpayers who did not have Archer MSA contributions for 2003 established Archer MSAs for 2004 prior to July 1, 2004. Of this total, 3,362 were reported as previously uninsured.

Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans. HSAs promote the same policy objectives as Archer MSAs on a more tax-favored basis. The rules relating to Archer MSAs and HSAs are similar. Like Archer MSAs, HSAs are tax-exempt trusts or custodial accounts which can be used to accumulate funds on a tax-free basis. Distributions used for qualified medical expenses are excluded from gross income. However, there are important differences that favor HSAs.

Contributions to an HSA made by or on behalf of any individual covered by a high deductible health plan are deductible. In addition, contributions made by an employer (including through salary reduction) are excludible from income and wages. In the case of Archer MSAs, only self-employed individuals and employees of small employers are eligible to have Archer MSAs, contributions cannot be made through salary reduction, and contributions cannot be made by both the employee and employer.

The definition of high deductible health plan for HSA purposes includes a lower annual deductible than that required for Archer MSAs.²⁰ For HSA purposes, a high deductible health plan is a plan that has a deductible that is at least \$1,000 for self-only coverage or \$2,000 for

¹⁷ H.R. Rep. No. 107-251.

¹⁸ Announcement 2005-12.

¹⁹ Returns of individuals who were reported as previously being uninsured do not count toward the applicable statutory limitation.

²⁰ There is no maximum annual deductible for an HSA high deductible health plan. The limit on out-of-pocket expenses is higher for HSAs than for Archer MSAs.

family coverage and that has an out-of-pocket expense limit that is no more than \$5,100 for self-only coverage and \$10,200 for family coverage (for 2005). The minimum annual deductible required for Archer MSAs is at least \$1,750 in the case of individual coverage and at least \$3,500 in the case of family coverage (for 2005). Unlike HSAs, the rules for Archer MSAs also include requirements for the maximum annual deductible.

The provisions for HSAs allow larger tax-favored contributions than that allowed for Archer MSAs. For 2005, the maximum deductible contribution that can be made to an Archer MSA is \$1,723 in the case of self-only coverage and \$3,938 in the case of family coverage, while the maximum deductible contribution that can be made to an HSA is \$2,650 in the case of self-only coverage and \$5,250 in the case of family coverage. In addition, additional contributions are allowed to HSAs of individuals who are age 55 or older.

The additional tax on distributions not used for medical expenses is lower in the case of HSAs; the additional tax is 10 percent in the case of HSAs rather than 15 percent in the case of Archer MSAs.

Unlike Archer MSAs, there is no limit on the number of HSAs that may be established, and HSAs were enacted on a permanent basis.

Some argue that those with existing Archer MSAs should be allowed to continue using MSAs during a limited transition period. This may not be necessary, however, as amounts can be rolled over into an HSA from an Archer MSA on a tax-free basis. The more tax-favored rules of HSAs are available to all individuals who currently have Archer MSAs. Some providers of Archer MSAs are currently facilitating roll-overs into HSAs. In rare cases in which Archer MSA providers are not offering HSAs, it is more tax advantageous for Archer MSA account holders to move their accounts to providers that do offer HSAs.

Some believe that Archer MSAs should be extended for a limited transition period as more companies begin to offer HSAs. They believe that until the HSA market is more developed, individuals should be allowed to establish Archer MSAs. Others counter that such transition is unnecessary, as most companies who offer Archer MSAs also offer HSAs.

Retaining Archer MSAs adds complexity to the tax system because of the existence of similar HSA provisions. In addition, retaining Archer MSAs creates a trap for the unwary, as HSAs provide more favorable tax benefits even in the case when no new contributions are made to the account.

E. Above-the-Line Deduction for Certain Higher Education Expenses

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.²¹ Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.²² The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

For taxable years beginning in 2004 or 2005, the maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2005.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,²³ and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain United States Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.²⁴ Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for exclusion under section 222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

²¹ Sec. 222.

²² The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

²³ Sec. 222(d)(1) and sec. 25A(g)(2).

²⁴ Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

Legislative History

The above-the-line deduction for qualified tuition and related expenses for higher education was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001.²⁵

President's Budget Proposal

No proposal.

Analysis

In general

All levels of government make substantial direct expenditures to subsidize post-secondary education. In addition, private educational organizations channel gifts from private persons into subsidies for the education of other persons. By exempting such organizations from income tax and permitting the gifts to such organizations to be deductible, additional implicit subsidies under the Code are created for education. Other subsidies for education provided by the Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the Hope and Lifetime Learning credits, the exclusion from income of earnings on education savings accounts and qualified tuition programs, and the exclusion from income of the interest on United States savings bonds used to pay for post-secondary education.²⁶

The deduction for qualified tuition and related expenses was enacted due to a concern that certain taxpayers were unable to utilize the full benefits of the Hope or Lifetime learning credits due to income limitations and to guard against the possibility that Congress might not extend the provisions that allow the education credits be claimed against the alternative minimum tax.

Analysts attempt to evaluate subsidies in terms of their efficiency, equity, and administrability. In this regard, subsidies to post-secondary education have been argued to improve both economic efficiency and to promote economic equity. As discussed further below, subsidies to education, such as the deduction, can improve economic efficiency when the social returns to education exceed the private returns to education. It is less likely that the deduction has a significant affect on the equity issue of affordable access to college, given that the deduction is designed to assist taxpayers with incomes beyond the eligibility levels for the education credits, a population that has had a high rate of college attendance even prior to the deduction. With regard to administrability and complexity, it has been suggested by numerous

²⁵ Note that the tuition deduction, though enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, sunsets prior to the general sunset in the Act.

²⁶ Certain income limits restrict some benefits.

observers that the education credits and the deduction could be combined for simplicity without sacrificing any policy goals because they have substantially similar objectives.²⁷ The following is a general discussion of the efficiency and equity issues regarding subsidies to education.

Efficiency as a goal of subsidies to education

Economists generally have a predilection for favoring the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a “positive externality.” On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society's perspective, total reduction in the rate of infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too few of the vaccinations. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

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

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces

²⁷ See, for example, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform tax Expenditures* (JCS-02-05), January 27, 2005; and National Taxpayer Advocate, *2004 Annual Report to Congress*, Publication 2104 (Rev. 12-2004).

positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, it is not possible to say whether new subsidies would increase or decrease economic efficiency without some empirical analysis of the social benefits that would arise from creating new subsidies.

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

Equity as a goal of subsidies to education

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

II. PROVISIONS RELATING TO BUSINESS TAXPAYERS

A. Investment and Employment

1. Research and experimentation (R&E) tax credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after December 31, 2005.

A 20-percent research tax credit also applies to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.²⁸

²⁸ The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses will be a phased-in ratio based on its actual

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer (sec. 41(f)(1)). Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.²⁹ If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (*i.e.*, the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or

research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

²⁹ Sec. 41(c)(4).

incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).³⁰

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which must constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control (sec. 41(d)(4)). Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.³¹ However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (Sec. 280C(c)). Taxpayers may alternatively elect to claim a reduced research tax credit amount (13 percent) under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Legislative History

The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current

³⁰ Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

³¹ Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

taxable year over the average of qualified research expenses incurred in the prior three taxable years. The credit was scheduled to expire December 31, 1985. The research tax credit was modified in the Tax Reform Act of 1986, which: (1) extended the credit through December 31, 1988; (2) reduced the credit rate to 20 percent; (3) tightened the definition of qualified research expenses eligible for the credit; and (4) enacted the separate university basic research credit.

The Technical and Miscellaneous Revenue Act of 1988 (“1988 Act”) extended the research tax credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 (“1989 Act”) effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also modified the method for calculating a taxpayer’s base amount (*i.e.*, by substituting the present-law method which uses a fixed-base percentage for the prior-law moving base which was calculated by reference to the taxpayer’s average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1990 extended the research tax credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

The Tax Extension Act of 1991 extended the research tax credit for six months (*i.e.*, for qualified expenses incurred through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993 (“1993 Act”) extended the research tax credit for three years--*i.e.*, retroactively from July 1, 1992 through June 30, 1995. The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience.

Although the research tax credit expired during the period July 1, 1995, through June 30, 1996, the Small Business Job Protection Act of 1996 (“1996 Act”) extended the credit for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime). In addition, the 1996 Act expanded the definition of start-up firms under section 41(c)(3)(B)(i), enacted a special rule for certain research consortia payments under section 41(b)(3)(C), and provided that taxpayers may elect an alternative research credit regime (under which the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage otherwise applicable and the credit rate likewise is reduced) for the taxpayer’s first taxable year beginning after June 30, 1996, and before July 1, 1997.

The Taxpayer Relief Act of 1997 (“1997 Act”) extended the research credit for 13 months--*i.e.*, generally for the period June 1, 1997, through June 30, 1998. The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable

year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury). The Tax and Trade Relief Extension Act of 1998 extended the research credit for 12 months, *i.e.*, through June 30, 1999.

The Ticket To Work and Work Incentive Improvement Act of 1999 extended the research credit for five years, through June 30, 2004, increased the rates of credit under the alternative incremental research credit regime, and expanded the definition of research to include research undertaken in Puerto Rico and possessions of the United States.

The Working Families Tax Relief Act of 2004 extended the research credit through December 31, 2005.

President's Budget Proposal

The President's budget proposal makes the research tax credit permanent.

Analysis

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm are cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency.³² However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. However, there is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.³³ Nevertheless, even if there were agreement that additional subsidies for research

³² This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

³³ See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. XCIV, (1992), M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993, and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43.

are warranted as a general matter, misallocation of research dollars across competing sectors of the economy could diminish economic efficiency. It is difficult to determine whether, at the present levels and allocation of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency.

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal Government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little consensus regarding magnitude of the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should increase research activities beyond what they otherwise would be. However, the present-law treatment of research expenditures does create certain complexities and compliance costs.

Scope of research activities in the United States and abroad

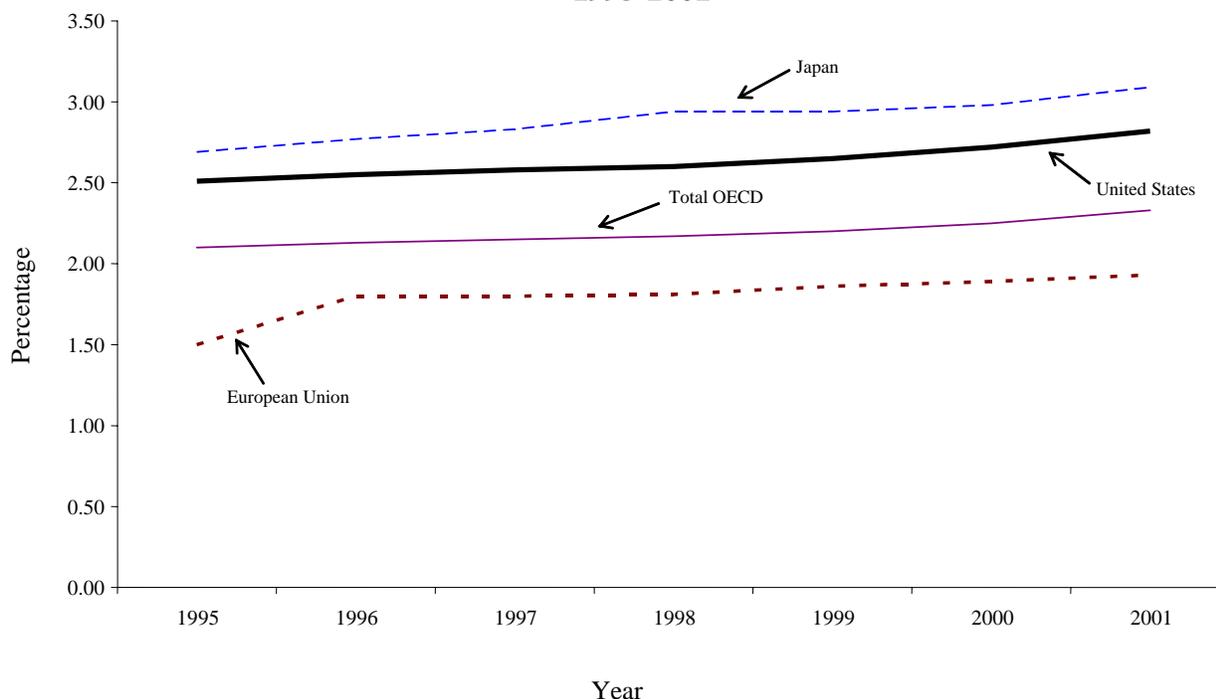
In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.8 percent of gross domestic product in 2002.³⁴ This rate of expenditure on research and development exceeds that of the European Union and the average of all countries that are members of the Organisation for Economic Co-operation and Development (“OECD”), but is less than that of Japan. See Figure 1, below. In 2001, expenditures on research and development in the United States represented 43.7 percent of all expenditures on research and development undertaken by OECD countries, were 55 percent greater than the total expenditures on research and development undertaken in the European Union, and were more than two and one half times such expenditures in Japan.³⁵ Expenditures on research and development in the United States have grown at an average real rate of 5.4 percent over the period 1995-2001. This rate of growth has exceeded that of Japan (2.8 percent), Germany (3.3 percent), France (2.4 percent for the period 1997-1999), Italy (2.7 percent for the period 1997-2000), and the United Kingdom, (2.3 percent), but is less than that of Canada (5.6 percent), Ireland (7.5 percent), and Spain (6.5 percent).³⁶

³⁴ Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Scoreboard, 2003*, (Paris: Organisation of Economid Co-operation and Development), 2003. The OECD, measuring in real 1995 dollars, calculates that the United States spent approximately \$253 billion on research and development in 2001.

³⁵ *Ibid.*

³⁶ *Ibid.* The OECD calculates the annual real rate of growth of expenditures on research and development for the period 1995-2001 in the European Union and in all OECD countries at 3.7 percent and 4.7 percent, respectively.

Figure 1.--Gross Domestic Expenditure on R&D as a Percentage of GDP, United States, Japan, the European Union, and the OECD, 1995-2001



Source: OECD Science, Technology and Industry Scoreboard, 2003.

The scope of present-law tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit is estimated to be \$4.8 billion for 2005. The related tax expenditure for expensing of research and development expenditures was estimated to be \$4.0 billion for 2005 growing to \$6.3 billion for 2009.³⁷ As noted above, the Federal Government also directly subsidizes research activities. For example, in fiscal 2004, the National Science Foundation made \$4.0 billion in grants, subsidies, and contributions to research activities, the Department of Defense financed \$11.5 billion in basic research, applied research, and advanced technology development, and the Department of Energy financed \$0.7 billion in research in high energy physics, \$1.0 billion in basic research in the sciences, \$0.6 billion in biological and environmental research, and \$197 million for research in advance scientific computing.³⁸

³⁷ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005, p. 30.

³⁸ Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006*, Appendix, pp. 1081-1085, 295-300 and 395-397.

Table 1 and Table 2 present data for 2002 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. In 2002, more than 15,000 taxpayers claimed more than \$5.8 billion in research tax credits.³⁹ Taxpayers whose primary activity is manufacturing claimed two thirds of the research tax credits claimed. Firms with assets of \$50 million or more claimed nearly 85 percent of the credits claimed. Nevertheless, as Table 2 documents, a large number of small firms are engaged in research and were able to claim the research tax credit.

³⁹ The \$5.8 billion figure reported for 2002 is not directly comparable to the \$4.8 billion tax expenditure estimate for 2005 reported in the preceding paragraph. The tax expenditure estimate accounts for the present-law requirement that deductions for research expenditures be reduced by research credits claimed. Also, the \$5.8 billion figure does not reflect the actual tax reduction achieved by taxpayers claiming research credits in 2002 as the actual tax reduction will depend upon whether the taxpayer had operating losses, was subject to the alternative minimum tax, or other aspects specific to each taxpayer's situation.

**Table 1.—Percentage Distribution of Firms Claiming Research Tax Credit
and Percentage of Credit Claimed by Sector, 2002**

Industry	Percent of Corporations Claiming Credit	Percent of Total R&E Credit
Manufacturing	47.76	66.68
Information	9.05	13.96
Professional, Scientific, and Technical Services	28.23	10.55
Wholesale Trade	4.08	2.83
Holding Companies	0.77	1.74
Finance and Insurance	1.36	1.63
Retail Trade	1.32	0.63
Health Care and Social Services	0.84	0.48
Administrative and Support and Waste Management and Remediation Services	0.33	0.47
Construction	0.27	0.19
Mining	0.48	0.16
Utilities	2.98	0.12
Agriculture, Forestry, Fishing and Hunting	0.38	0.06
Real Estate and Rental and Leasing	0.24	0.05
Other Services	1.46	0.04
Transportation and Warehousing	(1)	(1)
Arts, Entertainment, and Recreation	(1)	(1)
Accommodation and Food Services	(1)	(1)
Educational Services	(1)	(1)
Not Allocable	(1)	(1)
Wholesale and Retail Trade not Allocable	(1)	(1)

¹ Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation calculations from Internal Revenue Service, Statistics of Income data.

**Table 2.—Percentage Distribution of Firms Claiming Research Tax Credit
and of Amount of Credit Claimed by Firm Size, 2002**

Asset Size (\$)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	2.84	0.59
1 to 99,999	12.47	0.26
100,000 to 249,999	2.3	0.18
250,000 to 499,999	7.04	0.35
500,000 to 999,999	8.25	0.63
1,000,000 to 9,999,999	34.85	5.38
10,000,000 to 49,999,999	17.21	7.68
50,000,000 +	14.95	84.94

Note: Totals may not add to 100 percent due to rounding

Source: Joint Committee on Taxation calculations from Internal Revenue Service, Statistics of Income data.

Flat or incremental tax credits?

For a tax credit to be effective in increasing a taxpayer's research expenditures it is not necessary to provide that credit for all the taxpayer's research expenditures (*i.e.*, a flat credit). By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives where they will have the most effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of \$105 and Project B will generate cash flow with a present value of \$95. Suppose that the research cost of investing in each of these projects is \$100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Consider now the situation where a 10-percent flat credit applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to \$90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to \$90, this previously neglected project (with a present value of \$95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits attempt not to reward projects that would have been undertaken in any event but to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures. In the example above, if an incremental credit were properly targeted, the Government could spend the same \$20 in credit dollars and induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded

\$80. Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's base amount. Tax credits are provided only for amounts above this base amount.

Since a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures considered below their base amount receive no credit.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of price elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.⁴⁰ One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.⁴¹

⁴⁰ For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (*i.e.*, the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity--such as research scientists and engineers--is in short supply.

⁴¹ It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise--so called marginal research expenditures--need be subject to the credit to have a positive incentive effect.

Despite the central role of the measurement of the price elasticity of research activities, the empirical evidence on this subject has yielded quantitative measures of the response of research spending to tax incentives. While all published studies report that the research credit induced increases in research spending, early evidence generally indicated that the price elasticity for research is substantially less than one. For example, one early survey of the literature reached the following conclusion:

In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of -0.2 and -0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.⁴²

If it took time for taxpayers to learn about the credit and what sort of expenditures qualified, taxpayers may have only gradually adjusted their behavior. Such a learning curve might explain a modest measured behavioral effect.

A more recent survey of the literature on the effect of the tax credit suggests a stronger behavioral response, although most analysts agree that there is substantial uncertainty in these estimates.

[W]ork using US firm-level data all reaches the same conclusion: the tax price elasticity of total R&D spending during the 1980s is on the order of unity, maybe higher. . . . Thus there is little doubt about the story that the firm-level publicly

⁴² Charles River Associates, *An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive* (final report prepared for the National Science Foundation), February, 1985, p. G-14. The negative coefficient in the text reflects that a decrease in price results in an increase in research expenditures. Often, such elasticities are reported without the negative coefficient, it being understood that there is an inverse relationship between changes in the “price” of research and changes in research expenditures.

In a 1983 study, the Treasury Department used an elasticity of 0.92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. See, Department of the Treasury, “The Impact of Section 861-8 Regulation on Research and Development,” p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerably smaller. For example, the General Accounting Office (now called the Government Accountability Office) summarizes: “These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit’s impact.” See, *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: “While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3.” See, “The R&D Tax Credit and Other Technology Policy Issues,” *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191.

reported R&D data tell: the R&D tax credit produces roughly a dollar-for-dollar increase in reported R&D spending on the margin.⁴³

However this survey notes that most of this evidence is not drawn directly from tax data. For example, effective marginal tax credit rates are inferred from publicly reported financial data and may not reflect limitations imposed by operating losses or the alternative minimum tax. The study notes that because most studies rely on “reported research expenditures” that a “relabelling problem” may exist whereby a preferential tax treatment for an activity gives firms an incentive to classify expenditures as qualifying expenditures. If this occurs, reported expenditures increase in response to the tax incentive by more than the underlying real economic activity. Thus, reported estimates may overestimate the true response of research spending to the tax credit.⁴⁴

Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

⁴³ Bronwyn Hall and John Van Reenen, “How effective are fiscal incentives for R&D? A review of the evidence,” *Research Policy*, vol.29, 2000, p. 462. This survey reports that more recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to fully appreciate the incentive structure of the revised credit. See, Bronwyn H. Hall, “R&D Tax Policy During the 1980s: Success or Failure?” in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 7, (Cambridge: The MIT Press, 1993), pp. 1-35. Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, including an additional 76 firms, that had initially been excluded because they had been involved in merger activity, the estimated elasticities fell by half. See, James R. Hines, Jr., “On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s” in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, (Chicago: University of Chicago Press 1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, “R&D Tax Incentives and Manufacturing-Sector R&D Expenditures,” in James M. Poterba, editor, *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment*, (Washington, D.C.: National Academy Press), 1997. While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, “Does Government R&D Policy Mainly Benefit Scientists and Engineers?” *American Economic Review*, vol. 88, May, 1998, pp. 298-302.

⁴⁴ Hall and Van Reenen, “How effective are fiscal incentives for R&D? A review of the evidence,” p. 463.

Other policy issues related to the research and experimentation credit

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below base, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the alternative minimum tax ("AMT") or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.⁴⁵

Under present law, firms with research expenditures substantially in excess of their base amount may be subject to the 50-percent base amount limitation. In general, although these firms receive the largest amount of credit when measured as a percentage of their total qualified research expenses, their marginal effective rate of credit is exactly one half of the statutory credit rate of 20 percent (*i.e.*, firms subject to the base limitation effectively are governed by a 10-percent credit rate).

Although the statutory rate of the research credit is currently 20 percent, it is likely that the average marginal effective rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms are subject to various limitations discussed above yield estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, *i.e.*, between 12 and 15 percent.⁴⁶

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will drift from the firm's actual current qualified research expenditures. Therefore, increasingly over time there will be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms receive no credit and have no reasonable prospect of

⁴⁵ As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

⁴⁶ For a more complete discussion of this point see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 65-66.

ever receiving a credit, while other firms receive large credits (despite the 50-percent base amount limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average marginal effective rate of credit will decline while the revenue cost to the Federal Government increases.

Complexity and the research tax credit

Administrative and compliance burdens also result from the present-law research tax credit. The General Accounting Office (“GAO”) has testified that the research tax credit is difficult for the IRS to administer. The GAO reported that the IRS states that it is required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes. While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.⁴⁷ An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

Tax incentives such as the R&D tax credit ... typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company’s operational units. ... [I]s what the company calls “research and development” the same as the “qualified research” eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.⁴⁸

2. Work opportunity tax credit

Present Law

Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families

⁴⁷ Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, “Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight,” Committee on Finance, United States Senate, April 3, 1995.

⁴⁸ David R. Seltzer, “Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company,” *National Tax Journal*, vol. 50, September 1997, pp. 487-493.

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.

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under State or Federal law; (2) being a member of an economically disadvantaged family; and (3) having a hiring date within one year of release from prison or conviction.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer’s deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) 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. Therefore, 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).

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee for which the employer claims the welfare-to-work tax credit.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration date

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2006.

Legislative History

The work opportunity tax credit was enacted in the Small Business Job Protection Act of 1996, to replace the targeted jobs tax credit.⁴⁹ Initially, the work opportunity tax credit was available only for wages paid or incurred to qualified individuals who began work for an employer after September 30, 1996, and before October 1, 1997. The Taxpayer Relief Act of 1997 (“TRA 1997”) extended the credit for nine months, through June 30, 1998. TRA 1997 also expanded the Aid to Families with Dependent Children (“AFDC”) category,⁵⁰ extended the credit to certain Supplemental Security Income beneficiaries, and modified the minimum employment period and credit percentages. The Tax and Trade Relief Extension Act of 1998 extended the credit for one year (through June 30, 1999). The Tax Relief Extension Act of 1999 clarified the definition of first year of employment for credit purposes and extended the credit for 30 months (through December 31, 2001). The Job Creation and Worker Assistance Act of 2002 extended the credit for two years (through December 31, 2003). The Working Families Tax Relief Act of 2004 extended the credit for two years (through December 31, 2005).

President’s Budget Proposal

In general

The President’s budget proposal combines the work opportunity and welfare-to-work tax credits and extends the combined credit for one year. The welfare-to-work tax credit is discussed in II.A.4., below.

Targeted groups eligible for the combined credit

The combined credit is available on an elective basis for employers hiring individuals from one or more of all nine targeted groups. The nine targeted groups are the present-law eight groups with the addition of the welfare-to-work credit/long-term family assistance recipient as the ninth targeted group.

The proposal repeals the requirement that a qualified ex-felon be an individual certified as a member of an economically disadvantaged family.

Qualified wages

Qualified first-year wages for the eight work opportunity tax credit categories remain capped at \$6,000 (\$3,000 for qualified summer youth employees). No credit is allowed for second-year wages. In the case of long-term family assistance recipients, the cap is \$10,000 for

⁴⁹ The targeted jobs tax credit was initially enacted in 1978 as a substitute for the new jobs credit which was available in 1977 and 1978.

⁵⁰ The AFDC program was the predecessor to the Temporary Assistance to Needy Families program

both qualified first-year wages and qualified second-year wages. For all targeted groups, the employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

First-year wages.—For the eight work opportunity tax credit categories, the credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) 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. Therefore, the maximum credit per employee for members of any of the eight work opportunity tax credit targeted groups generally 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 remains \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). For the welfare-to-work/long-term family assistance recipients, the maximum credit equals \$4,000 per employee (40 percent of \$10,000 of wages).

Second-year wages.—In the case of long-term family assistance recipients the maximum credit is \$5,000 (50 percent of the first \$10,000 of qualified second-year wages).

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

Coordination is no longer necessary once the two credits are combined.

Effective date

The proposal is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2005, and before January 1, 2007.

Analysis

Overview of policy issues

The WOTC is intended to increase the employment and earnings of targeted group members. The credit is made available to employers as an incentive to hire members of the targeted groups. To the extent the value of the credit is passed on from employers to employees, the wages of targeted group employees will be higher than they would be in the absence of the credit.⁵¹

⁵¹ For individuals with productivity to employers lower than the minimum wage, the credit may result in these individuals being hired and paid the minimum wage. For these cases, it would be clear that

The rationale for the WOTC is that employers will not hire certain individuals without a subsidy, either because the individuals are stigmatized (e.g., convicted felons) or the current productivity of the individuals is below the prevailing wage rate. Where particular groups of individuals suffer reduced evaluations of work potential due to membership in one of the targeted groups, the credit may provide employers with a monetary offset for the lower perceived work potential. In these cases, employers may be encouraged to hire individuals from the targeted groups, and then make an evaluation of the individual's work potential in the context of the work environment, rather than from the job application. Where the current productivity of individuals is below the prevailing wage rate, on-the-job-training may provide individuals with skills that will enhance their productivity. In these situations, the WOTC provides employers with a monetary incentive to bear the costs of training members of targeted groups and providing them with job-related skills which may increase the chances of these individuals being hired in unsubsidized jobs. Both situations encourage employment of members of the targeted groups, and may act to increase wages for those hired as a result of the credit.

As discussed below, the evidence is mixed on whether the rationales for the credit are supported by economic data. The information presented is intended to provide a structured way to determine if employers and employees respond to the existence of the credit in the desired manner.

Efficiency of the credit

The credit provides employers with a subsidy for hiring members of targeted groups. For example, assume that a worker eligible for the credit is paid an hourly wage of w and works 2,000 hours during the year. The worker is eligible for the full credit (40 percent of the first \$6,000 of wages), and the firm will receive a \$2,400 credit against its income taxes and reduce its deduction for wages by \$2,400. Assuming the firm faces the full 35-percent corporate income tax rate, the cost of hiring the credit-eligible worker is lower than the cost of hiring a credit-ineligible worker for 2,000 hours at the same hourly wage w by $\$2,400(1-.35) = \$1,560$.⁵² This \$1,560 amount would be constant for all workers unless the wage (w) changed in response to whether or not the individual was a member of a targeted group. If the wage rate does not change in response to credit eligibility, the WOTC subsidy is larger in percentage terms for lower wage workers. If w rises in response to the credit, it is uncertain how much of the subsidy remains with the employer, and therefore the size of the WOTC subsidy to employers is uncertain.

To the extent the WOTC subsidy flows through to the workers eligible for the credit in the form of higher wages, the incentive for eligible individuals to enter the paid labor market may increase. Since many members of the targeted groups receive governmental assistance

the credit resulted in the worker receiving a higher wage than would have been received in the absence of the credit (i.e., zero).

⁵² The after-tax cost of hiring this credit eligible worker would be $((2,000)(w)-2,400)(1-.35)$ dollars. This example does not include the costs to the employer for payroll taxes (e.g., Social Security, Medicare and unemployment taxes) and any applicable fringe benefits.

(e.g., Temporary Assistance for Needy Families or food stamps), and these benefits are phased out as income increases, these individuals potentially face a very high marginal tax rate on additional earnings. Increased wages resulting from the WOTC may be viewed as a partial offset to these high marginal tax rates. In addition, it may be the case that even if the credit has little effect on observed wages, credit-eligible individuals may have increased earnings due to increased employment.

The structure of the WOTC (the 40-percent credit rate for the first \$6,000 of qualified wages) appears to lend itself to the potential of employers churning employees who are eligible for the credit. This could be accomplished by firing employees after they earn \$6,000 in wages and replacing them with other WOTC-eligible employees. If training costs are high relative to the size of the credit, it may not be in the interest of an employer to churn such employees in order to maximize the amount of credit claimed. Empirical research in this area has not found an explicit connection between employee turnover and utilization of WOTC's predecessor, the Targeted Jobs Tax Credit ("TJTC").⁵³

Job creation

The number of jobs created by the WOTC is certainly less than the number of certifications of eligible workers. To the extent employers substitute WOTC-eligible individuals for other potential workers, there is no net increase in jobs created. This could be viewed as merely a shift in employment opportunities from one group to another. However, this substitution of credit-eligible workers for others may not be socially undesirable. For example, it might be considered an acceptable trade-off for a targeted group member to displace a secondary earner (e.g., a spouse or student working part-time) from a well-to-do family.

In addition, windfall gains to employers or employees may accrue when the WOTC is received for workers that the firm would have hired even in the absence of the credit. When windfall gains are received, no additional employment has been generated by the credit. Empirical research on the employment gains from the TJTC has indicated that only a small portion of the TJTC-eligible population found employment because of the program. One study indicates that net new job creation was between five and 30 percent of the total certifications. This finding is consistent with some additional employment as a result of the TJTC program, but with considerable uncertainty as to the exact magnitude.⁵⁴

A necessary condition for the credit to be an effective employment incentive is that firms incorporate WOTC eligibility into their hiring decisions. This could be done by determining credit eligibility for each potential employee or by making a concerted effort to hire individuals from segments of the population likely to include members of targeted groups. Studies examining this issue through the TJTC found that some employers made such efforts, while

⁵³ See, for example, Macro Systems, Inc., *Final Report of the Effect of the Targeted Jobs Tax Credit Program on Employers*, U.S. Department of Labor, 1986.

⁵⁴ Macro Systems, Inc., *Impact Study of the Implementation and Use of the Targeted Jobs Tax Credit: Overview and Summary*, U.S. Department of Labor, 1986.

other employers did little to determine eligibility for the TJTC prior to the decision to hire an individual.⁵⁵ In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

Complexity issues

Extension of the WOTC for one year provides some continuity and simplifies tax planning during that period for taxpayers and practitioners. Some argue that a permanent extension will have a greater stabilizing effect on the tax law. They point out that temporary expirations, like the current one, not only complicate tax planning but also deter some taxpayers from participating in the program. Each time the expiration date for the provision approaches, taxpayers may be less likely to begin participation in the program. Any such effect would likely grow stronger as a result of program expirations, even when the program is retroactively extended.⁵⁶ Others argue that allowing the credit to expire could eliminate a windfall benefit to certain taxpayers and reduce complexity in the Code.

3. Welfare-to-Work tax credit

Present Law

Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. 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 such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax 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. For these purposes, family assistance is assistance provided under the IV-A program of the Social Security Act (“Temporary Assistance for Needy Families”).

Qualified wages

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than for the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax credit, which includes simply cash wages, the definition of wages for the welfare-to-work tax

⁵⁵ For example, see U.S. General Accounting Office, Targeted Jobs Tax Credit: Employer Actions to Recruit, Hire, and Retain Eligible Workers Vary (GAO-HRD 91-33), February 1991.

⁵⁶ For example, the work opportunity tax credit, which had expired on January 1, 2004, was retroactively extended on October 4, 2004, by the Working Families Tax Relief Act of 2004 (Pub. L. No. 108-311).

credit includes cash wages paid to an employee plus amounts paid by the employer for: (1) educational assistance excludable under a section 127 program; (2) health plan coverage for the employee, but not more than the applicable premium defined for purposes of the health care continuation rules 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.

Calculation of the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients during the first two years of employment. The maximum credit is 35 percent of the first \$10,000 of qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Qualified first-year wages are defined as qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning with the day the individual began work for the employer. Qualified second-year wages are defined as qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning immediately after the first year of that individual's employment for the employer. The maximum credit is \$8,500 per qualified employee.

Minimum employment period

No credit is allowed for qualified wages paid to a member of the targeted group unless they work at least 400 hours or 180 days in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee for which the employer claims the welfare-to-work tax credit.

Other rules

The welfare-to-work tax credit incorporates directly or by reference many of the rules applicable to the work opportunity tax credit (see item II.A.2., above).

Expiration date

The welfare-to-work tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2006.

Legislative History

The welfare-to-work tax credit was enacted in the Taxpayer Relief Act of 1997. Initially the credit was available only for wages paid or incurred to qualified individuals who began work for an employer on or after January 1, 1998, and before May 1, 1999. The Tax and Trade Relief Extension Act of 1998 extended the credit for two months (through June 30, 1999). The Tax Relief Extension Act of 1999 extended the credit for 30 months (through December 31, 2001). The Job Creation and Worker Assistance Act of 2002, extended the credit for two years (through

December 31, 2003). The Working Families Tax Relief Act of 2004 extended the credit for two years (through December 31, 2005).

President's Budget Proposal

A discussion of the President's budget proposal to combine the work opportunity tax credit and welfare-to-work tax credit and extend the combined credit for one year is included in II.A.2., above.

Analysis

Policy issues

Proponents of the credit argue that extension of the welfare-to-work tax credit encourages employers to hire, train, and provide certain benefits and more permanent employment to longer-term welfare recipients. Opponents argue that tax credits to employers for hiring certain classes of individuals do not increase overall employment and may disadvantage other deserving job applicants. There are also concerns about the efficiency of tax credits as an incentive to potential employees to enter the job market, as well as an incentive for employers to retain such employees after they no longer qualify for the tax credit. It is argued that basing of the credit on only the first two years of a person's employment motivates employers to replace an employee whose wages no longer qualify for the tax credit with another employee whose wages do qualify. For a more detailed discussion of these issues, refer to the analysis section of the extension of the work opportunity tax credit, immediately above (see item II.A.2., above).

Complexity issues

The expiration of the credit has complicated tax planning for affected taxpayers by creating uncertainty. The temporary extension may reduce or eliminate that uncertainty for some time. Some argue, however, either the permanent expiration of the credit or the permanent extension of the credit would provide reduced uncertainty permanently. Preference between these latter two alternatives would correlate to perceived efficacy of the welfare-to-work credit generally.

If both the welfare-to-work credit and work opportunity credit were extended, then simplification could be achieved by combining the two credits. Such a combination would eliminate dual certification and filing requirements. It would also reduce tax law complexity by eliminating the need for two separate but similar sets of rules for the two credits.

4. Indian employment tax credit

Present Law

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the

employer with respect to certain employees.⁵⁷ The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed.

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjusted for inflation after 1993 is currently \$35,000). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a 5 percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.⁵⁸

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before January 1, 2006.

Legislative History

The provision was added to the Code by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The credit was to expire on December 31, 2003. It has been extended twice. First, the Job Creation and Workers Assistance Act of 2002 (Pub. L. No. 107-147), extended the credit an additional year, through December 31, 2004. Subsequently, the Working Families Tax Relief Act of 2004 (Pub. L. No. 108-311), extended the credit through December 31, 2005.

President's Budget Proposal

No proposal.

⁵⁷ Sec. 45A.

⁵⁸ Sec. 45A(c)(5).

Analysis

The Indian employment credit was created to encourage businesses to employ members of Indian tribes by establishing or expanding nongaming operations on Indian reservations. Labor-intensive businesses employing a significant number of qualified employees could find the credit valuable. However, some may argue that the incremental nature of the credit (based on amounts from 1993) adds to its complexity. In 2001, the most recent year for which data is available, taxpayers claimed approximately \$54 million in credits under this provision.

Like the Work Opportunity Tax Credit (“WOTC”) and Welfare to Work (“WTW”) credits, the Indian employment credit serves a similar purpose in encouraging the employment of a targeted group, however, there are significant differences in the credits. The Indian employment credit is an incremental credit (based on the excess of eligible costs over amounts incurred in 1993), while WOTC and WTW are not. The Indian employment credit is location dependent (e.g., substantially all of the services must be performed on an Indian reservation), while WOTC and WTW do not require a specific location for the performance of services. In addition, the WOTC and WTW credits are temporary credits for employers to take with regard to an individual. For example, the WTW incentive is worth up to \$8,500 per qualified employee over a period of two years. The WOTC incentive is worth up to \$2,400 per qualified employee for the employee’s first year of wages only. The Indian employment credit incentive may be taken annually, up to \$4,000 per qualified employee, until the authority for the credit expires.

5. Accelerated depreciation for business property on an Indian Reservation

Present Law

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) are determined using the following recovery periods:

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

“Qualified Indian reservation property” eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not “qualified Indian reservation property” if it is placed in service for purposes of conducting gaming activities. Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property

located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 or section 4(1) of the Indian Child Welfare Act of 1978. For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The accelerated depreciation deduction for Indian reservations allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation deduction is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2006.

Legislative History

Accelerated depreciation for Indian reservations was added to the Code by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The provision was to expire on December 31, 2003. It has been extended twice. First, the Job Creation and Workers Assistance Act of 2002 (Pub. L. No. 107-47), extended the provision for property placed in service through December 31, 2004. Subsequently, the Working Families Tax Relief Act of 2004 (Pub. L. No. 108-311), extended the provision for property placed in service through December 31, 2005.

The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) clarified the definition of Indian reservation. Section 3(d) of the Indian Financing Act of 1974 includes not only officially designated Indian reservations and public domain Indian allotments, but also all “former Indian reservations in Oklahoma,” which covers most of the State of Oklahoma even though parts of such “former Indian reservations” may no longer have a significant nexus to an Indian tribe. The Taxpayer Relief Act of 1997 added the present law requirements for interpreting section 3(d) of the Indian Financing Act of 1997 as it relates to former Indian reservations in Oklahoma.

President’s Budget Proposal

No proposal.

Analysis

The provision was intended to encourage businesses to establish or expand nongaming operations on Indian reservations. By permitting accelerated depreciation for qualified property, the provision creates a tax incentive for such operations. The accelerated depreciation for qualified property creates a tax incentive for such operations by reducing the present-value after-tax cost of investing in qualifying property, which in turn increases the return on investments in qualified property. The shorter recovery periods can have the effect of substantially decreasing the tax liability of a business. However, the degree of benefit for each business varies based on the particular nature and situation of the business. For businesses engaged in activities that rely heavily on large depreciable assets, such as those involved in power generation, the shorter recovery periods could be very attractive.

Some might argue that the location of business property on a reservation does not ensure that significant benefits will flow through to the tribal members living on such reservation. Indian ownership of the business property is not required. In addition, over two-thirds of the land in Oklahoma meets the definition of Indian reservation and qualifies for accelerated depreciation. Oklahoma currently has no current “Indian reservations” but it does have a very high Native American population.⁵⁹

No data are currently available to measure the effectiveness of this provision in spurring economic development on Indian reservations.

6. 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant improvements

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.⁶⁰ This rule applies regardless of whether the lessor or the

⁵⁹ Senate Staff, *Indian Land Tax Credit Issues: Federal Property and Employment Tax Benefits for Indian Lands* (October 1997) www.lsb.state.ok.us/senate/publications/issue_papers/IPIndianTax.html.

⁶⁰ Sec. 168(i)(8). 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.

lessee places the leasehold improvements in service.⁶¹ If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service.⁶² However, exceptions exist for certain qualified leasehold improvements and certain qualified restaurant property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006. Qualified leasehold improvement property is recovered using the straight-line method. Leasehold improvements placed in service in 2006 and later will be subject to the general rules described above.

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), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or 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. However, if a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is

⁶¹ Former 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. The Tax Reform Act of 1986 repealed these provisions.

⁶² Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not 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 v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method.

Legislative History

The 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property was enacted as part of the American Jobs Creation Act of 2004. Prior to that Act, such improvements and property were generally subject to a 39-year cost recovery period.

Analysis

The reduction of the cost recovery period for qualified leasehold improvements and qualified restaurant property from 39 years to 15 years was intended to more accurately reflect the true economic useful life of such property.⁶³ Conforming the recovery period of a property class as closely as possible to the economic life of the property results in a more accurate measure of economic income derived from such property. Additionally, to the extent that the depreciation schedules of other property are designed to accurately measure economic depreciation, a depreciation schedule for an asset class that deviates from economic depreciation may distort investment decisions. If the depreciation schedule provides for faster cost recovery than economic depreciation, an incentive is created to invest in such assets relative to other assets. Similarly, if the depreciation schedule provides for slower cost recovery than economic depreciation, a disincentive to invest in such assets is created. If the depreciation schedules uniformly match economic depreciation, the depreciation system will be generally neutral as to the choice of investment across asset classes. Such neutrality promotes economically efficient investment choices by helping to insure that investments with the highest post-tax return (the return that the investor cares about) are also those with the highest pre-tax return (the measure of the value of the investment to society). When MACRS was enacted in 1986, neutrality was cited as one of the reasons for extending the recovery period for real property (and, by extension, leasehold improvements). At that time, the Congress noted that a neutral tax system allows the economy to most quickly adapt to changing economic needs.⁶⁴

There is some economic evidence that the present-law 39-year recovery period leads to higher effective tax rates on investments in commercial real estate than in other investments.⁶⁵ This study does not estimate the "correct" economic life, but suggests that 39 years may be too long. However, even admitting that a 39-year recovery period is too long, it would not necessarily follow that a reduction in the recovery period for certain investments in commercial

⁶³ H.R. Rep. No. 108-548, at 122 (2004).

⁶⁴ S. Rep. No. 99-313, at 96 (1986).

⁶⁵ Jane G. Gravelle, "Whither Tax Depreciation?" *National Tax Journal*, vol. 54, September 2001.

real estate creates an overall economic improvement. This is because neutrality has not been attained as distortions between different types of investment in commercial real estate as well as distortions between investments in commercial real estate and other investments remain.

In addition to neutrality, depreciation policy objectives include reducing complexity and stimulating investment. While permitting depreciation of individual assets over their actual economic lives would be consistent with the goal of neutrality, determination of each asset's individual economic life would be complex and potentially contentious between taxpayers and the IRS. For this reason, the MACRS system generally provides a small number of depreciation classes and relatively short recovery periods.⁶⁶ Depreciation schedules may also be accelerated relative to economic depreciation for the purpose of stimulating investment. However, if the acceleration is not provided uniformly across asset classes, the depreciation system would not be neutral in the choice of investment.

When weighing the various policy objectives in determining the appropriate recovery period for a specific asset class, it could be argued that it is preferable to err on the side of a recovery period which is shorter than the estimated economic life of property within the class. Grouping assets together into classes for purposes of simplicity necessitates that not all assets will have recovery periods equal to their estimated economic lives. If accelerated depreciation methods are an appropriate policy to stimulate investment, then a recovery period longer than economic life would tend to counteract the policy justification for accelerated methods. Thus, it may be preferable for cost recovery periods to trend toward the shorter end of the range of economic lives within a property class. A recovery period which is too short results in improper measure of economic income, but a recovery period longer than economic life results in both an improper measure of economic income and a disincentive to investment. In addition, a shorter recovery period may compensate for the fact that depreciation deductions are based on nominal values and therefore become less valuable over time in an inflationary environment.

With respect to leasehold improvements made by lessees, it could be argued that permitting depreciation over the remaining lease term (including any expected renewal periods) would be a more appropriate policy than a 15-year cost recovery period because the cost of the investment would be recovered over the life of the investment. However, a uniform recovery period for all similar property (regardless of lease term) may be desirable for purposes of simplicity and administrability, especially in light of the difficulties in anticipating whether a lease is likely to be renewed. Although lease terms differ, it is possible that lease terms for commercial real estate typically are shorter than the 39-year recovery period which applies under present law to leasehold improvements placed in service after December 31, 2005. Thus, the 15-year recovery period may be more reflective of average lease terms.

While average remaining lease term may be an appropriate factor in determining the recovery period for leasehold improvements placed in service by lessees, it may not be relevant with respect to leasehold improvements by lessors, who will continue to own the improvements

⁶⁶ *Id.* at 95.

after the current lease has expired. Thus, it is unclear why leasehold improvements placed in service by the lessor should be subject to the special 15-year recovery period.

With respect to restaurant property, it could be argued that restaurant improvements should be treated similarly to improvements to all other retail establishments. Proponents of the shorter life for restaurant property argue that restaurants are more specialized structures than other commercial buildings, and therefore they require more frequent updates, shortening the economic useful life of prior improvements. Proponents also argue that restaurants experience more traffic and remain open for longer hours than most retail properties, resulting in more rapid deterioration of restaurant property than other commercial property. However, some restaurants are open only at common meal times, and others experience periods of reduced usage (and foot traffic) in between common meal times. Thus, it is unclear whether restaurants experience greater foot traffic than other retail establishments. Moreover, it is also unclear whether a significant relationship exists between foot traffic and the rate of deterioration or obsolescence of commercial property.

Assigning a shorter recovery period to specific types of improvements which meet certain criteria is a source of complexity in the tax code which some may view as unjustified. Moreover, it is not clear why certain improvements, but not others, qualify for the special recovery period. Current-law distinctions regarding the type of improvements that qualify for the 15-year recovery period potentially raise difficult compliance and enforcement issues for the taxpayer and the IRS.

Overall, the provision may promote neutrality between investment in qualifying property and other property classes by more closely approximating the economic life of qualifying property, but the provision may also disturb the existing neutrality between investment in qualifying property and similar nonqualifying property (e.g., non-leasehold retail property improvements) to the extent that the similar nonqualifying property has a similar economic life. In addition, the provision encourages investment in qualifying property, but it adds complexity by creating an additional property class. In considering whether an extension of the 15-year cost recovery period for leasehold improvements and restaurant property is appropriate, the unique characteristics of such property should be considered within the context of the overall policy goals of the depreciation system, including neutrality, simplicity, and investment incentives.

B. Energy and Environment

1. Credit for electricity produced from certain renewable resources

Present Law

In general

An income tax credit is allowed for the production of electricity from qualified facilities (sec. 45). Qualified facilities comprise wind energy facilities, “closed-loop” biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. In addition, an income tax credit is allowed for the production of refined coal.

Credit amounts and credit period

In general

The base amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit was 1.8 cents per kilowatt hour for 2004. A taxpayer may claim credit for the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits. The amount of credit a taxpayer may claim is phased out as the market price of electricity (refined coal in the case of refined coal) exceeds certain threshold levels.

Reduced credit amounts and credit periods

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the 10-year credit period is reduced to five years commencing on the date the facility is placed in service. In general, for eligible pre-existing facilities and other facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the otherwise allowable credit amount is 0.75 cent per kilowatt hour, indexed for inflation measured after 1992.

Credit applicable to refined coal

The amount of the credit for refined coal is \$4.375 per ton (also indexed for inflation after 1992 and would have equaled \$5.350 per ton for 2004).

Other limitations on credit claimants and credit amounts

In general, in order to claim the credit, a taxpayer must own the qualified facility and sell the electricity produced by the facility (or refined coal in the case of refined coal) to an unrelated party. A lessee or operator may claim the credit in lieu of the owner of the qualifying facility in the case of qualifying open-loop biomass facilities originally placed in service on or before the date of enactment and in the case of a closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee or operator of a facility owned by a governmental unit.

For all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit for electricity produced from renewable sources is a component of the general business credit (sec. 38(b)(8)).

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

Qualified facilities

Wind energy facility

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2006.

Closed-loop biomass facility

A closed-loop biomass facility is a facility that uses any organic material from a plant which is planted exclusively for the purpose of being used at a qualifying facility to produce electricity. In addition, a facility can be a closed-loop biomass facility if it is a facility that is modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both coal and other biomass, but only if the modification is approved under the Biomass Power for Rural Development Programs or is part of a pilot project of the Commodity Credit Corporation.

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2006. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other

biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2006.

Open-loop biomass (including agricultural livestock waste nutrients) facility

An open-loop biomass facility is a facility using open-loop biomass (including agricultural livestock waste nutrients) to produce electricity. Open-loop biomass is defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill residues, other than spent chemicals from pulp manufacturing, precommercial thinnings, slash, and brush. Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying open-loop biomass does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. In addition, open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (cofiring) beyond such fossil fuel required for start up and flame stabilization.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure.

To be a qualified facility, an open-loop biomass facility must be placed in service after October 22, 2004 and before January 1, 2006, in the case of facility using agricultural livestock waste nutrients and must be placed in service at any time prior to January 1, 2006 in the case of a facility using other open-loop biomass.

Geothermal facility

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after the date of enactment and before January 1, 2006.

Solar facility

A solar facility is a facility that uses solar energy to produce electricity. To be a qualified facility, a solar facility must be placed in service after the date of enactment and before January 1, 2006.

Small irrigation facility

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is not less than 150 kilowatts and less than five megawatts. To be

a qualified facility, a small irrigation facility must be originally placed in service after the date of enactment and before January 1, 2006.

Landfill gas facility

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004 and before January 1, 2006.

Trash combustion facility

Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004 and before January 1, 2006.

Refined coal facility

A qualifying refined coal facility is a facility producing refined coal that is placed in service after the date of enactment and before January 1, 2009. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxides and either SO₂ or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal the fuel must be sold by the taxpayer with the reasonable expectation that it will be used for the primary purpose of producing steam.

Legislative History

The Energy Policy Act of 1992 created section 45 as a production credit for electricity produced from wind and closed-loop biomass for production from certain facilities placed in service before July 1, 1999. The Ticket to Work and Work Incentives Improvement Act of 1999 added poultry waste as a qualifying energy source, extended the placed in service date through December 31, 2001, and made certain modifications to the requirements of qualifying wind facilities. The Job Creation and Worker Assistance Act of 2002 extended the placed in service date through December 31, 2003. The Working Families Tax Relief Act of 2004 extended the generally applicable placed in service date for wind facilities, closed-loop biomass facilities, and poultry waste facilities through December 31, 2005. The American Jobs Creation Act modified the provision to add as qualified facilities open-loop biomass (including agricultural livestock waste nutrients⁶⁷), geothermal energy, solar energy, small irrigation power, and municipal solid waste (both landfill gas and trash combustion facilities). The American Jobs Creation Act of

⁶⁷ The definition of agricultural livestock waste nutrients subsumes poultry waste, so the Act repealed, prospectively, poultry waste facilities as a separate category of qualified facility.

2004 defined refined coal as a qualifying resource eligible for credit. The American Jobs Creation Act of 2004 also made other modifications.

At the time of passage of the credit, the House Committee on Ways and Means stated that “the credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources.”⁶⁸ The House Committee on Ways and Means further stated that the purpose of the original expiration date (June 30, 1999) was “to provide the committee with the opportunity to assess the effectiveness of the credit in encouraging the utilization of renewable energy sources.”⁶⁹

President’s Budget Proposal

The proposal extends the placed in service date for facilities that produce electricity from wind, closed-loop biomass, open-loop biomass (other than agricultural waste nutrients), and landfill gas to include electricity from those facilities placed in service before January 1, 2008.⁷⁰ The proposal does not extend the placed in service date for facilities that produce electricity from agricultural waste nutrient facilities, geothermal facilities, solar power facilities, small irrigation facilities, or trash combustion facilities.

In addition, the proposal permits taxpayers to claim a credit at 60 percent of the otherwise allowable credit for electricity produced from open-loop biomass (0.45 cents per kilowatt-hour before adjustment for inflation indexing) for electricity produced from open-loop biomass (other than agricultural waste nutrients) co-fired in coal plants during the three-year period January 1, 2006 through December 31, 2008.

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

Analysis

For a taxpayer with a positive tax liability, the electricity production credit is equivalent to a subsidy that pays the taxpayer for each kilowatt-hour of electricity produced in addition to the price at which the producer sells the electricity. That is, a tax credit that reduced a taxpayer’s tax liability and therefore increases the taxpayer’s bottom line can be thought of as equivalent to a direct subsidy that is paid to the taxpayer to improve the taxpayer’s top line. Measured at a rate per kilowatt-hour, the direct subsidy equivalent of the electricity production tax credit is $c/(1-t)$,

⁶⁸ House of Representatives, Rept.102-474, Part 6, “Comprehensive National Energy Policy Act,” H.R. 776, p. 42.

⁶⁹ *Ibid.*

⁷⁰ The extended placed in service date also will apply to the date of modification of facilities modified to co-fire closed-loop biomass with coal, other biomass, or both coal and other biomass.

where c is the credit rate per kilowatt-hour and t is the taxpayer's marginal tax rate.⁷¹ If the taxpayer is a corporate taxpayer with a marginal tax rate of 35 percent, the subsidy equivalent of the 1.5 cents-per-kilowatt-hour base credit amount is approximately 2.3 cents per kilowatt-hour of electricity produced. The subsidy equivalent amount of the 2004 level of the credit (1.8 cents per kilowatt hour) is approximately 2.8 cents per kilowatt-hour. For producers of electricity from qualifying renewable sources this "subsidy" would be in addition to the wholesale price they receive from the sale of power. Data on wholesale prices are not readily available. However, the Department of Energy reports data on retail prices. The Department of Energy reports that the national average retail price of electricity for the first 11 months of 2004 was 7.59 cents per kilowatt-hour, with the average for residential customers of 8.97 cents per kilowatt-hour and the average for industrial customers of 5.12 cents per kilowatt-hour.⁷² Thus, the tax credit for production of electricity is equivalent to a subsidy equal to nearly 37 percent of the average retail price of electricity. As electricity prices vary by region, the rate of subsidy is higher in some parts of the country and lower in other parts of the country.

The electricity production tax credit economically is equivalent to an open-ended subsidy, available to any taxpayer without having to make an application to a government

⁷¹ To see that $c/(1-t)$ is the direct subsidy equivalent of the electricity production tax credit, the analysis will focus on marginal after-tax profit. As such, the analysis can disregard all fixed costs of production at a qualifying facility. Let R denote the revenue per kilowatt-hour from the sale of electricity and let X be the variable cost expense of generating one kilowatt-hour of electricity. Let h be the number of kilowatt-hours of electricity produced and let c be the credit rate per kilowatt-hour of electricity produced. Finally let t be the taxpayer's marginal tax rate.

If the taxpayer qualifies to claim the electricity production tax credit, the taxpayer's after-tax profit per kilowatt-hour of electricity production is given by equation (1).

$$(1) (R-X) \cdot h \cdot (1-t) + c \cdot h = \text{marginal after-tax profit.}$$

Now assume that instead of a tax credit the taxpayer is paid a subsidy, S , per kilowatt-hour of electricity produced. The taxpayer's marginal after-tax profit per kilowatt-hour of electricity production under this scenario is given by equation (2).

$$(2) (S+R-X) \cdot h \cdot (1-t) = \text{marginal after-tax profit.}$$

If one asks what value of S yields the same marginal after-tax profit as the electricity production tax credit, c , by equating equations (1) and (2), one finds that the subsidy equivalent to the production tax credit is:

$$S = c/(1-t)$$

⁷² Energy Information Administration, *Monthly Energy Review*, February 2005. The reported average retail prices include any State and local sales or excise taxes applicable to electricity within various jurisdictions.

agency for the subsidy.⁷³ If a taxpayer believes that sum of electricity prices plus the credit creates a profitable rate of return, the taxpayer will invest in a qualifying facility. In theory, investors should invest in qualifying facilities up to the point where the return from additional investment in qualifying facilities is no greater than alternative investments. With the tax credit equal for all taxpayers and because qualifying renewable energy sources are not uniformly available at equal cost, the credit is more valuable to investors in certain facilities in certain geographic locations, compared to similar facilities in other geographic locations. For example, sustained winds are stronger in some parts of the country than in other parts of the country, but assume that in neither of two locations would a wind facility be profitable in the absence of a subsidy. If cost of construction and operation and access to the electricity grid are equivalent in the two locations, an investment in a qualifying wind facility should be more profitable in the windy location than in the less windy location. One would expect investment to occur in the most profitable locations first. In this sense, the tax credit mechanism is efficient in that potential investors will attempt to exploit the most profitable opportunities to produce electricity from qualifying renewable resources first. As a result, the investors will provide the most amount of qualifying renewable electricity with the least amount of investment.

However, a tax credit is not likely to be a fully efficient subsidy mechanism from the perspective of the government's fisc. The credit amount is invariant for any specific category of qualified facility. While two investments may both be estimated to be profitable enough to merit investment by prospective investors, because of one's access to relatively inexpensive qualified renewable energy resources compared to the other, the one proposed investment is likely to be more profitable than the other proposed investment. By providing the same uniform credit, the government pays more subsidy than is necessary to bring the one investment in a qualified facility on line. For example, there may be some potential qualifying facilities that would be profitable investments in the absence of any subsidy, but they may claim the credit. As several States have enacted "renewables mandates," requiring that electricity providers include a minimum amount of electricity from renewable sources as a condition of sale to consumers, this source of inefficiency (paying for production that will happen regardless of the credit) will grow.

A subsidy, such as the credit, can promote economic efficiency when there is a divergence between the private costs of an activity and the social costs of the activity. Such a divergence is called an "externality." Analysts commonly identify pollution as an externality because pollution imposes costs on society in terms of environmental degradation and health costs that are not reflected in the cost of producing the good or service that creates the pollution. By subsidizing non-polluting, or less polluting activities, the tax credit for production of electricity from renewable sources can produce a more economically efficient outcome. To be fully efficient, however, the subsidy should be equated to the incremental social benefit created by the displacement of a polluting source with a less polluting source. The incremental social benefit from the displacement of current sources of electricity production with electricity produced from renewable sources derives from the net change in all types of pollution from the

⁷³ Of course, building codes and other regulations may require government approval for a proposed investment in a qualifying facility, but a taxpayer does not require approval before claiming the implicit subsidy offered by the credit.

current source of production to the renewable source of production. With a credit at a uniform rate applicable to multiple technologies, ranging from wind power to burning paper mill residues, it is unlikely that the subsidy provided by the credit will equal the incremental social benefit produced by each separate technology.

Some analysts have argued that there is social benefit meriting subsidy in the potential for domestic renewable resources to displace foreign energy sources, principally oil. Oil-fired electricity generation accounted for approximately 3.1 percent of net electricity generation in the United States in 2003 and the amount of petroleum consumed in electricity production was approximately 3.1 percent of refined petroleum products produced in the United States in 2003.⁷⁴ If a credit-eligible facility displaces electricity produced at an unsubsidized facility, market economics dictate that it generally would be the highest cost producer that is displaced. It need not be the case that a petroleum-fired electricity generating facility is the highest-cost producer. In addition, if a petroleum-fired electricity generating facility ceases production, thereby reducing the demand for petroleum, it need not be the case that the reduction in demand for petroleum leads to a reduction in imported oil. As the demand for petroleum falls, market economics dictate that it generally would be the highest-cost suppliers that are displaced. The highest-cost suppliers of petroleum may be domestic producers.

The production credit for electricity from qualified facilities has been available to taxpayers since 1993, but until the passage of the AJCA the credit was available only with respect to wind facilities, closed-loop biomass facilities, and poultry waste facilities. In practice, investors have only found it profitable to invest in wind facilities. Since 1993, the year before which qualified wind facilities became eligible for the credit, the annual production of electricity from wind has quadrupled.⁷⁵ See Figure 2 below. Figure 2 reveals that the most rapid growth did not occur in the first five years after the credit was created, but over the past six years.⁷⁶ Over the past decade technological gains have been made in the design and efficiency of wind turbines. Figure 2 suggests that the credit was not solely responsible for the growth in production of electricity from wind, but it is not possible from available data to identify the extent to which the credit, technological improvements, the price of alternative production sources (*e.g.*, fossil fuel facilities), State regulation, or other factors contributed to growth of wind power. Nevertheless, even with this significant growth, wind power accounted for less than three-tenths of one percent of total net generation of electricity in the United States in 2003.⁷⁷

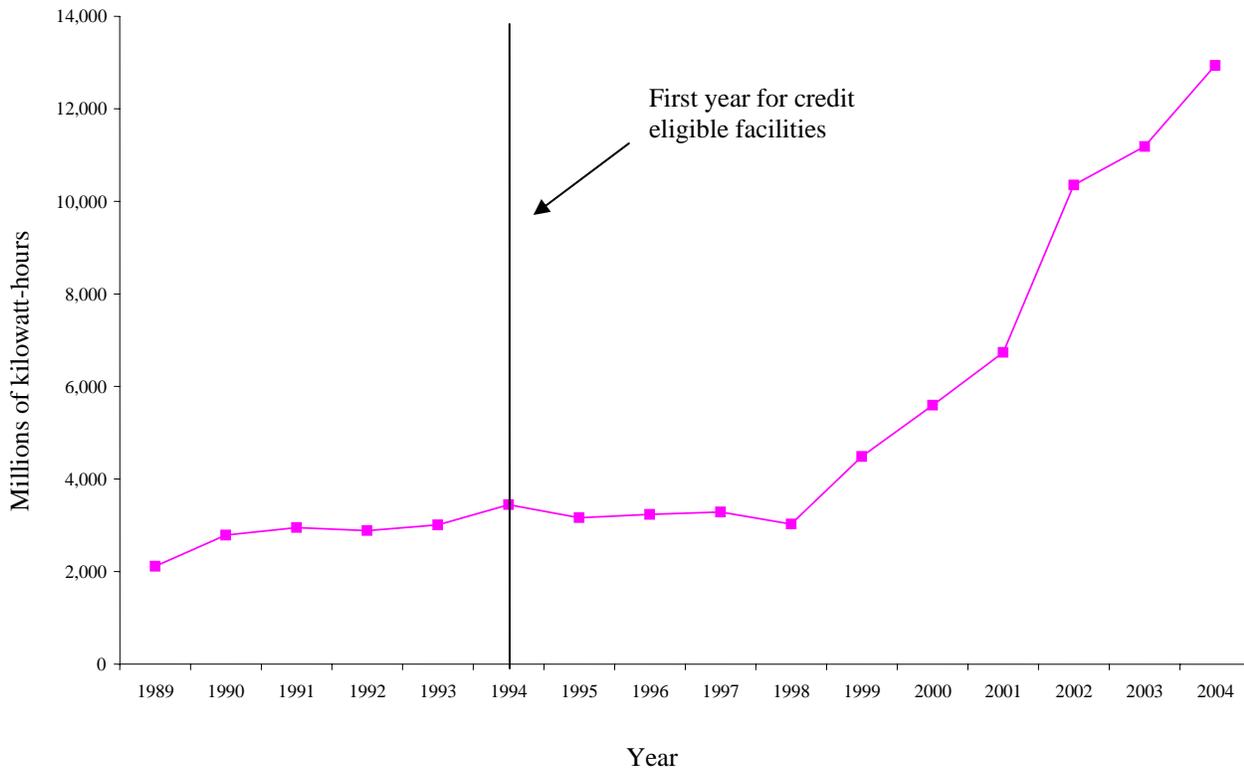
⁷⁴ Energy Information Administration, *Monthly Energy Review*, February 2005

⁷⁵ *Ibid.*

⁷⁶ As noted above, the tax credit for production from wind facilities was enacted in 1992, effective for facilities placed in service after 1993. The Energy Information Administration reports that in 1998, six years after the credit was enacted effective for new facilities in 1994 and thereafter, the production of electricity from wind was 3,026 million kilowatt-hours compared to a production of 3,006 million kilowatt-hours in 1993. *Ibid.*

⁷⁷ *Ibid.*

**Figure 2.—Electricity Generation from Wind, 1989-2004
(millions of kilowatts-hours)**



Source: Energy Information Administration.

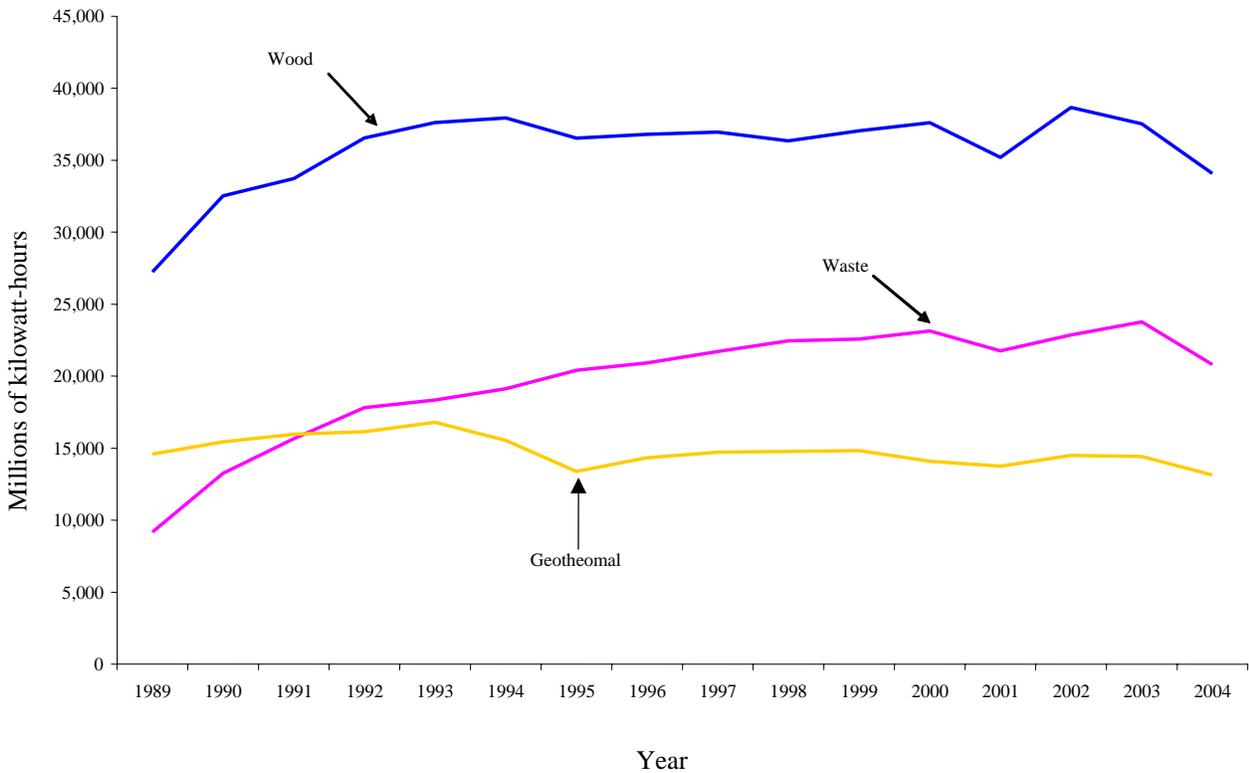
Note: 2004 total includes output only through November.

Since the inception of the credit, other sources of renewable energy, many of which are now eligible under present law, have been more significant sources of renewable energy than wind power. Figure 3, below, reports the annual production of electricity from wood (including wood, black liquor, and other wood waste), waste (including municipal solid waste, landfill gas, sludge waste, tires, agricultural byproducts, and other biomass), and geothermal. These three categories accounted for 1.9 percent of total net generation of electricity in the United States in 2003.⁷⁸ Electricity generation from solar power, both solar thermal and photovoltaic sources, has been substantially less, but growing. Electricity generation from solar sources totaled 251 million kilowatt-hours in 1990 and 534 million kilowatt-hours in 2003.⁷⁹

⁷⁸ *Ibid.*

⁷⁹ *Ibid.*

**Figure 3.—Electricity Generation from Other Renewable Sources, 1989-2004
(millions of kilowatt-hours)**



Source: Energy Information Administration.
 Note: 2004 total includes output only through November.

2. Expensing of brownfields remediation costs

Present Law

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

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The

expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*⁸⁰ and section 263A, are treated as qualified environmental remediation expenditures.

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

In the case of property for which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under this provision.

Eligible expenditures are those paid or incurred before January 1, 2006.

Legislative History

The Taxpayer Relief Act of 1997 created section 198 to permit taxpayers to expense certain qualified environmental remediation expenditures paid or incurred after August 5, 1997, in tax years ending after that date. The provision included a termination date, which excluded from the provision expenditures paid or incurred after December 31, 2000. The Ticket to Work and Work Incentives Improvement Act of 1999 extended the termination date to December 31, 2001. The Consolidated Appropriations Act, 2001, further extended the termination date to December 31, 2003. The Consolidated Appropriations Act, 2001, also modified the definition of “qualified contaminated site” under section 198(c). The Working Families Tax Relief Act of 2004 extended the termination date to December 31, 2005.

⁸⁰ *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer’s construction of capital facilities must be capitalized under section 263(a)(1)).

At the time of passage of the provision, the Senate Committee on Finance stated that the provision was intended to “encourage the cleanup of contaminated sites, as well as to eliminate uncertainty regarding the appropriate treatment of environmental remediation expenditures for Federal tax law purposes.”⁸¹

President’s Budget Proposal

The President’s budget proposal eliminates the requirement that expenditures must be paid or incurred before January 1, 2006, to be deductible as qualified environmental remediation expenditures. Thus, the provision becomes permanent.

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

Analysis

The provision is intended to encourage environmental remediation, and general business investment, at contaminated sites. With respect to environmental remediation tax benefits as an incentive for general business investment, it is possible that the incentive may have the effect of distorting the location of new investment, rather than increasing investment overall.⁸² If the new investments are offset by less investment in neighboring, but not qualifying, areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

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

The present-law provision also may simplify tax planning and investment planning by providing more clarity regarding expenses that must be capitalized and those that can be expensed. However, in general, the provision treats expenditures at certain geographic locations differently from otherwise identical expenditures at other geographic locations. Such distinctions generally require additional record keeping on the part of taxpayers and more complex tax return filings. Concomitantly, such distinctions increase the difficulty of IRS audits.

⁸¹ S. Rpt. No. 105-33 at 110.

⁸² For a discussion of the economic effects of targeting economic activity to specific geographic areas, see Leslie E. Papke, “What Do We Know About Enterprise Zones,” in James M. Poterba, ed., *Tax Policy and the Economy*, vol. 7 (Cambridge, MA: The MIT Press), 1993.

By making the present law provision permanent, the President's proposal may simplify tax planning and investment planning by taxpayers by providing more certainty.

3. Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.⁸³ 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.

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.⁸⁴ Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.⁸⁵ The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").⁸⁶ The 100-percent net-income limitation for marginal production has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2006.

Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

Legislative History

The 100-percent net income limitation as it applies to marginal wells has been suspended since 1998. The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) first suspended the limitation

⁸³ Secs. 611-613.

⁸⁴ Sec. 613A.

⁸⁵ Sec. 613A(c).

⁸⁶ Sec. 613(a).

for taxable years beginning after December 31, 1997 and before January 1, 2000.⁸⁷ In 1999, the Ticket to Work and Work Incentives Improvement Act of 1999 (Pub. L. No. 106-170), further suspended the limitation for taxable years beginning before January 1, 2002. Although the extension was added at conference, both the House Committee on Ways and Means, and the Senate Committee on Finance had reported similar bills from their committees. The reasons for change were substantially similar:

The Committee notes that oil is, and will continue to be, vital to the American economy. The Committee observes that low oil prices have created substantial economic hardship in the oil industry and particularly in those communities where the majority of jobs are related to the oil and gas industry. The current economic hardship in the industry could lead to business failures and job losses. The Committee finds it appropriate to extend the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells. The Committee believes that by reducing current taxable income, less cash will have to be devoted to income tax payments, and the current cash position of many such businesses will improve, helping them weather this current economic storm.⁸⁸

⁸⁷ The Senate provision would have suspended the 100-percent-of-net-income property limitation for any taxable year beginning in a calendar year in which the annual average wellhead price per barrel for crude oil (within the meaning of section 29(d)(2)(C)) is below \$14 per barrel. The Senate Committee on Finance report stated, “The Committee believes that a suspension of the net income property limitation for marginal oil and gas production is appropriate if the price of oil falls to unexpectedly low levels, to prevent such wells from being plugged and potentially losing their production in the long run.” S. Rpt. No. 105-33.

⁸⁸ S. Rpt. 106-201, at 12. The Senate bill, S. 1792, would have extended the suspension of the limitation to include taxable years beginning after December 31, 1999 and before January 1, 2001. The House bill, H.R. 2923, would have extended the suspension of the limitation somewhat longer to include taxable years beginning after December 31, 1999 and before January 1, 2005. The House Report noted:

The Committee notes that oil is, and will continue to be, vital to the American economy. The Committee observes that low oil prices have created substantial economic hardship in the oil industry and particularly in those communities where the majority of jobs are related to providing this vital commodity to the nation. Skilled workers and industry know-how will be critical to the exploration for and production of oil and gas in the future. The Committee, therefore, is concerned that the current economic hardship in the industry could lead to business failures and job losses. The Committee understands that many of these businesses are cash starved. The Committee finds it appropriate to extend the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells. The Committee believes that by reducing current taxable income, less cash will have to be devoted to income tax payments and the current cash position of many such businesses will improve, helping them weather this current economic storm.

In 2002, the limitation was suspended for taxable years beginning before January 1, 2004, by the Jobs Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147). Finally, the Working Families Tax Relief Act of 2004 (Pub. L. No. 108-311) suspended the limitation a fourth time for taxable years beginning before January 1, 2006.⁸⁹

President's Budget Proposal

No proposal.

Analysis

The provision potentially allows taxpayers to take greater depletion deductions. In the absence of a suspension, percentage depletion for marginal wells would be limited to 100 percent of net income from the property. There may be some taxpayers that find they can take greater deductions in the absence of a limitation, thereby further reducing their tax liability and offsetting taxable income from other properties, as well as other activities. This may enable them to potentially reinvest more revenue into drilling for oil and gas and invest in new technologies to extend the life of existing fields. Such actions would be consistent with a national energy policy of trying to decrease dependence on foreign oil.

It should be noted, however, that unlike other cost recovery systems, percentage depletion deductions over the life of the subject property are not limited to the taxpayer's cost basis in such property. To the extent of any excess, the taxpayer is afforded deductions which exceed actual cash expenditures. Thus, it could be argued that the benefits of percentage depletion, even with the net income limitation, represent sufficient incentive for taxpayers to engage in domestic oil and gas exploration and drilling.

In addition, if the present-law provision was intended as a temporary measure to assist taxpayers in times of depressed oil prices, further suspension of the limitation may not be warranted. Domestic crude oil prices are currently above \$50.00 per barrel.⁹⁰ When the suspension was first put into place, domestic crude oil averaged \$10.87 per barrel.⁹¹ Figure 1,

See, H.R. Rept. 106-344 at 16. The Senate bill, S. 1792, would have extended the suspension of the limitation to include taxable years beginning after December 31, 1999 and before January 1, 2001.

⁸⁹ The 2002 and 2004 extensions were added during the conference of the respective bills.

⁹⁰ The *Wall Street Journal*, March 2, 2005, p. B7, reported the spot price of West Texas Intermediate at \$51.69 per barrel in trading on March 1, 2005.

⁹¹ The average price is the average domestic first purchase price for crude oil reported by the Energy Information Administration. Energy Information Administration, *Monthly Energy Review* (February 2005).

below, reports the average annual first purchase price of domestic crude oil for the period 1995 through 2004.⁹²

**Figure 4.—Average Annual First Purchase Price of Domestic Crude Oil,
1995-2004
(Dollars per Barrel)**



Note: 2004 is average through November.
Source: Energy Information Administration.

In light of current oil prices, it could be argued that it is profitable to operate marginal wells and there is not a current economic hardship to be addressed.

⁹² The data from the Energy Information Administration are available only through November 2004. The average price figure for 2004 reflects only the first eleven months of the year.

C. Miscellaneous

1. Deduction for corporate donations of computer technology

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.⁹³

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."⁹⁴ This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2005.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.⁹⁵ The original use of the property must be by the donor or the donee,⁹⁶ and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person)

⁹³ Sec. 170(e)(1).

⁹⁴ Secs. 170(e)(4) and 170(e)(6).

⁹⁵ If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

⁹⁶ This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.⁹⁷

Legislative History

The enhanced deduction for computer contributions was enacted as part of the Taxpayer Relief Act of 1997. The temporary nature of the deduction was added as part of the conference agreement to the 1997 Act. The conference agreement intended that the provision expire after three years, but a drafting error established a two-year provision, which required a 1998 technical correction to extend the deduction to contributions made in taxable years beginning before January 1, 2001. The Community Renewal Tax Relief Act of 2000 extended the enhanced deduction for an additional three years, to contributions made in taxable years beginning before January 1, 2004. The Working Families Tax Relief Act of 2004 extended the deduction an additional two years, to contributions made in taxable years beginning before January 1, 2006.

President's Budget Proposal

The President's budget proposal extends the enhanced deduction to donations made in taxable years beginning before January 1, 2007.

Analysis

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

Proponents argue that present law helps accelerate the nationwide adoption of computer technology in education and helps avail more individuals internet access through their local public library. Proponents argue that more time is needed to achieve higher levels of computer

⁹⁷ Sec. 170(e)(6)(C).

access and that it is appropriate to extend the present-law enhanced deduction to help attain this outcome. However, some argue that if the intended policy is to promote adoption of computer technology in education and internet access via public libraries, it would be more direct and efficient to provide a direct government subsidy instead of making a tax expenditure through the tax system, which cannot be monitored under the annual budgetary process.

The enhanced deduction, and thus its extension, creates complexities for the taxpayer and the IRS. The enhanced deduction is allowed to the donor only for equipment that the donee does not trade or sell. Generally, once the equipment is in the hands of the donee it is difficult for the donor to monitor the use of the equipment. Likewise, it is difficult for the IRS to ascertain whether a claim for an enhanced deduction is valid. Also, the enhanced deduction is predicated on an ascertainable fair market value of the computer technology.⁹⁸ With the rapid advances in the field, such determinations are difficult at times. Computers lose value quickly.⁹⁹ However, third-party tracking of prices for used computer equipment do exist. In this regard, the limitation to equipment less than three years old may aid taxpayer compliance and IRS administration. Nonetheless, because value is uncertain, the IRS is at a disadvantage in enforcing the provision. To ease administration and provide greater certainty for taxpayers and the IRS, the enhanced deduction generally could be based not on the value of the computer equipment but on the taxpayer's basis in the equipment and the equipment's age. For example, equipment one year old or less could receive a deduction of up to twice the taxpayer's basis; equipment between one and two years old could receive a deduction of a lesser multiple of the taxpayer's basis; and equipment two years old or greater could receive a deduction of an even lesser multiple of the taxpayer's basis.¹⁰⁰ The reduction in the deduction over time could be justified by the generally rapid decrease in value of computer equipment over time. The deduction still would be an enhanced deduction because the taxpayer would receive more than its basis in the property. Under such an alternative, the basis multiple would have to be determined based on information about the markup of new items and the rate of loss of value over time. However, assuming that the relationship between value and basis varies over time, the basis multiple should be adjusted regularly.

Taxpayers who contribute computer equipment from inventory must consider multiple factors to ensure that they deduct the permitted amount (and no more than the permitted amount)

⁹⁸ The enhanced deduction is equal to the lesser of basis plus one-half of the item's appreciated value (that is, one-half basis plus one-half fair market value) or two times basis. The two times basis limitation is binding only if the fair market value of the item exceeds three times the item's basis. Thus, a measure of fair market value always is necessary.

⁹⁹ A recent study concludes that "[n]ot surprisingly, our empirical results indicate that PCs lose value at a rapid pace. ... [T]he value of a PC declines roughly 50 percent, on average, with each year of use, implying that a newly installed PC can be expected to be nearly worthless after five or six years of service. Mark E. Doms, Wendy E. Dunn, Stephen D. Oliner, and Daniel E. Sichel, "How Fast Do Personal Computers Depreciate? Concepts and New Estimates," in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 18, (Cambridge, MA: The MIT Press), 2004

¹⁰⁰ As under present law, the deduction could not exceed fair market value.

with respect to contributed equipment. Taxpayers who are required to maintain inventories for such items must consider the fair market value of the contributed equipment, the basis of the equipment (and twice the basis of the equipment), and the resulting income that would be realized if the equipment were sold, and coordinate the resulting contribution deduction with the determination of cost of goods sold.¹⁰¹

2. Parity in the application of certain limits to mental health benefits

Present Law

The Internal Revenue Code (the “Code”), the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Public Health Service Act (“PHSA”) contain provisions under which 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 (“mental health parity requirements”). In the case of a group health plan which provides benefits for mental health, the mental health parity requirements do not affect the terms and conditions (including cost sharing, limits on numbers of visits or days of coverage, and requirements relating to medical necessity) relating to the amount, duration, or scope of mental health benefits under the plan, except as specifically provided in regard to parity in the imposition of aggregate lifetime limits and annual limits.

The Code imposes an excise tax on group health plans which fail to meet the mental health parity requirements.¹⁰² The excise tax is equal to \$100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements.¹⁰³ 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 mental health parity requirements do not apply to group health plans of small employers¹⁰⁴ nor do they apply if their application results in an increase in the cost under a group health plan of at least one percent. Further, the mental health parity requirements do not require group health plans to provide mental health benefits.

¹⁰¹ Such taxpayers must remove the amount of the contribution deduction for the contributed equipment inventory from opening inventory, and do not treat the removal as a part of cost of goods sold. IRS Publication 526, *Charitable Contributions*, pp. 7-8.

¹⁰² Sec. 9812.

¹⁰³ Sec. 4980D.

¹⁰⁴ In general, a small employer is, with respect to a calendar year and a plan year, an employer who employed an average of at least two but not more than 50 employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year. Sec. 4980D(d)(2).

Legislative History

The Mental Health Parity Act of 1996 (“MHPA”) amended ERISA and the PHSa to include the mental health parity requirements. Initially, the provisions of the MHPA were effective only with respect to plan years beginning on or after January 1, 1998, and applied to benefits for services furnished before September 30, 2001. The Taxpayer Relief Act of 1997 added to the Code the mental health parity requirements imposed under the MHPA, and imposed an excise tax on group health plans which fail to meet the requirements. The Code requirements had same the effective date as the ERISA and PHSa provisions. The mental health parity requirements in all three statutes were extended to apply to benefits for services furnished on or after December 31, 2002, by the Departments of Labor, Health and Human Services, and Education, and Related Agencies Appropriations Act, 2002.

The Job Creation and Worker Assistance Act of 2002 amended the effective date of the mental health parity requirements in the Code to provide that it is inapplicable to benefits for services furnished on or after September 30, 2001, and before January 10, 2002, and extended them to apply to benefits for services furnished on or before December 31, 2003. The ERISA and PHSa provisions were extended for one year to apply to benefits for services furnished before December 31, 2003, by the Mental Health Parity Reauthorization Act of 2002. The Mental Health Parity Reauthorization Act of 2003, extended these provisions for an additional year to apply to benefits for services furnished before December 31, 2004.

The Working Families Tax Relief Act of 2004 extended the ERISA and PHSa provisions relating to mental health parity to benefits for services furnished before January 1, 2006. It also extended the Code provisions relating to mental health parity to benefits for services furnished on or after the date of enactment and before January 1, 2006.

President’s Budget Proposal

No proposal.

Analysis

The mental health parity requirements are enforced through an integrated statutory system found in ERISA, PHSa, and the Code. The mental health parity requirements in ERISA generally apply to all group health plans other than governmental plans, church plans, and certain other plans. These provisions also apply to health insurance issuers that offer health insurance coverage in connection with such group health plans. The requirements in the PHSa generally apply to health insurance issuers that offer health insurance coverage in connection with group health plans and to certain State and local governmental plans. The Code’s mental health parity requirements generally apply to all group health plans other than governmental plans, but they do not apply to health insurance issuers. Even in the absence of the mental health parity requirements in the Code, covered plans would still have to comply with the mental health parity requirements under ERISA and the PHSa.

The issues raised with respect to the mental health parity provisions are primarily health issues, rather than tax policy issues. The primary focus of the mental health parity requirements is to require that annual or lifetime limits for mental health benefits are not lower than those

applicable to medical and surgical benefits. Employer-provided mental health coverage is not mandated by the requirements, nor are employers prevented from imposing terms and conditions on mental health benefits offered, provided the terms and conditions are not less favorable than those applicable to other types of care..

From an employer's perspective, balancing the level of the health benefits with cost containment is an important aspect of providing health coverage. Employers seeking to attract and retain employees may find that it is in their best interest to offer the most comprehensive health benefits possible while incurring manageable costs. Employee benefits, including health benefits, may factor into individuals' decisions about whether to accept a job with or remain with a particular employer.

Cost containment may be a reason that employers limit mental health benefits under group health plans. Additionally, limiting benefits for mental healthcare under a plan may facilitate providing health care to a greater number of people. Alternatively, it may be argued that untreated mental health problems ultimately result in other medical issues, thus, mental health care is an important part of total health care. Some believe that overall health care costs generally are lower as a result of providing mental health coverage.

Some feel that the limited nature of the mental health parity requirements ensures that employers will not eliminate mental health benefits in response to the requirements. The requirements permit employers whose plans offer mental health benefits through group health plans to choose from several options for maintaining cost controls on mental health benefits. Flexibility to define the scope of benefits, establish cost-sharing requirements, and impose limits on hospital stays and out-patient visits is maintained under the requirements.

On the other hand, although lifetime and annual caps applicable only to mental health benefits are eliminated under the mental health parity requirements, employers may still change their group health plans to include other generally-applicable caps, such as limits on inpatient and outpatient days or higher coinsurance rates. As a result, individuals who receive mental health benefits may have to pay higher copayments and deductibles for their benefits. This may actually raise the overall expenditures of those who use mental health services. Another possible response by employers to the mental health parity requirements is to lower the dollar caps applicable to general medical care to offset the increase in mental health coverage or to drop mental health coverage altogether. Some argue that because small employers are exempted from the mental health parity requirements, the provisions do not reach many employees who need mental health care services. However, some point out that small employers were exempted from the requirements due to cost concerns; health insurance coverage tends to be more expensive on a per-employee basis for small employers than for large employers.

III. PROVISIONS RELATING TO STATE AND LOCAL GOVERNMENTS

A. District of Columbia

1. Tax incentives for investment in the District of Columbia

Present Law

In general

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the “D.C. Zone”), within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Zone designation remains in effect for the period from January 1, 1998, through December 31, 2005. In general, the tax incentives available in connection with the D.C. Zone are a 20-percent wage credit, an additional \$35,000 of section 179 expensing for qualified zone property, expanded tax-exempt financing for certain zone facilities, and a zero-percent capital gains rate from the sale of certain qualified D.C. zone assets.

Wage credit

A 20-percent wage credit is available to employers for the first \$15,000 of qualified wages paid to each employee (i.e., a maximum credit of \$3,000 with respect to each qualified employee) who (1) is a resident of the D.C. Zone, and (2) performs substantially all employment services within the D.C. Zone in a trade or business of the employer.

Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the wage credit, regardless of whether the employer meets the definition of a “D.C. Zone business.”¹⁰⁵

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.¹⁰⁶ Wages are not to be taken into account for purposes

¹⁰⁵ However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

¹⁰⁶ Sec. 280C(a).

of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.¹⁰⁷ In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.¹⁰⁸ The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.¹⁰⁹

Section 179 expensing

In general, a D.C. Zone business is allowed an additional \$35,000 of section 179 expensing for qualifying property placed in service by a D.C. Zone business.¹¹⁰ The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$200,000 (\$400,000 for taxable years beginning after 2002 and before 2008). The term "qualified zone property" is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or business by the taxpayer.¹¹¹ Special rules are provided in the case of property that is substantially renovated by the taxpayer.

Tax-exempt financing

A qualified D.C. Zone business is permitted to borrow proceeds from tax-exempt qualified enterprise zone facility bonds (as defined in section 1394) issued by the District of Columbia.¹¹² Such bonds are subject to the District of Columbia's annual private activity bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed \$15 million and may be issued only while the D.C. Zone designation is in effect.

¹⁰⁷ Secs. 1400H(a), 1396(c)(3)(A), and 51A(d)(2).

¹⁰⁸ Secs. 1400H(a), 1396(c)(3)(B), and 51A(d)(2).

¹⁰⁹ Sec. 38(c)(2).

¹¹⁰ Sec. 1397A.

¹¹¹ Sec. 1397D.

¹¹² Sec. 1400A.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.¹¹³ In general, a qualified “D.C. Zone asset” means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent.

In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. Zone asset that is (1) a capital asset or property used in the trade or business as defined in section 1231(b), and (2) acquired before January 1, 2006. Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified D.C. Zone business.¹¹⁴ However, no gain attributable to periods before January 1, 1998, and after December 31, 2010, is qualified capital gain.

Legislative History

The Omnibus Budget Reconciliation Act of 1993 authorized the designation of nine empowerment zones and 95 enterprise communities to provide tax incentives for businesses to locate within certain geographic areas designated by the Secretaries of Housing and Urban Development and Agriculture. Portions of the District of Columbia were designated an enterprise community in 1994 and thus became eligible to issue tax-exempt enterprise zone facility bonds.

The Taxpayer Relief Act of 1997 created the D.C. Zone designation and related tax incentives effective for the period from January 1, 1998, through December 31, 2002. The Community Renewal Tax Relief Act of 2000 extended the designation and related tax incentives of the D.C. Zone for one additional year, through December 31, 2003. The Working Families Tax Relief Act of 2004 generally extended the designation and related tax incentives of the D.C. Zone for two additional years, through December 31, 2005.

President’s Budget Proposal

No proposal. Although there is no current proposal of the President to extend the D.C. Zone designation, the President’s budget proposals contain a separate proposal that would establish “opportunity zones.” Under this proposal, the D.C. Zone automatically is eligible to apply for designation as an opportunity zone. If opportunity zone status were granted, the D.C. Zone would qualify for a different mix of tax incentives through December 31, 2009.

¹¹³ Sec. 1400B.

¹¹⁴ However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally related test does not apply).

Analysis

The D.C. Zone designation and related tax incentives were enacted to reduce the District of Columbia's high levels of poverty, unemployment, and economic distress. Extending the D.C. Zone incentives through 2005 was intended to encourage the continued economic redevelopment of distressed areas.

Some argue that the designation of the D.C. Zone as an area in need of special tax incentives always was intended to be a temporary provision. Either the tax incentives would help contribute to a successful revitalization of the designated area, rendering their continued provision unnecessary, or the incentives would not have the desired economic effect, in which case they were not working as intended and should be discontinued or modified. The extensions of the designation and incentives in 2000 and 2004 could be viewed as necessary to permit the incentives to have the intended effect, for a full evaluation of such effect, and to be comparable with the lifespans of other empowerment zones.

Whether the D.C. Zone should expire depends in part on a determination of whether the tax incentives have been effective in reducing poverty and unemployment levels in the D.C. Zone. In general, studies of the effectiveness of enterprise community, empowerment zone, and renewal community tax incentives are few and lacking in analytical detail, making such a determination difficult. The most comprehensive such study, the Housing and Urban Development Interim Assessment,¹¹⁵ found that employment of zone residents nationwide increased from 1995 to 2000 and that larger businesses were more likely to utilize zone tax benefits than smaller businesses. Although this information may be helpful to analyzing trends with respect to the D.C. Zone, it is not specific to the D.C. Zone and does not address benefits such as the capital gain exclusion.

Some argue that if the designation is allowed to expire, the D.C. Zone area should continue to be monitored to determine whether economic activity in the area declines substantially as a result, and thus whether at some future time the designation and tax benefits should be reinstated. Others argue that although there has been economic revitalization of parts of the District of Columbia, there are areas within the District that still exhibit signs of high levels of poverty and unemployment. Under this view, the tax incentives should not be allowed to expire completely, but should be modified, perhaps to target a different set of census tracts or by providing a different mix of incentives.

If the designation is not allowed to expire, some argue that a long-term extension, such as for five or more years may be preferable to a short-term extension of one or two years. Such short-term extensions create uncertainty for businesses and employers within the designated area,

¹¹⁵ Herbert, Scott, et al., "Interim Assessment of the Empowerment Zones and Enterprise Communities (EZ/EC) Program: A Progress Report, prepared for the U.S. Department of Housing and Urban development," November 2001; see also U.S. General Accounting Office, *Community Development: Business Use of Empowerment Zone Tax Incentives*, (GAO/RCED-99-253, September 1999) (noting that few businesses used the available tax-exempt bond financing; predominantly because businesses did not know of their existence).

which may affect economic decisions with respect to future expansion or investment opportunities.

2. District of Columbia Homebuyer Tax Credit

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of \$2,500 each. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000-\$130,000 for joint filers). For purposes of eligibility, “first-time homebuyer” means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2005.¹¹⁶

Legislative History

The District of Columbia first-time homebuyer credit was enacted as part of the Taxpayer Relief Act of 1997, and was scheduled to expire on December 31, 2000. The Tax Relief Extension Act of 1999 extended the first-time homebuyer credit for one year, through December 31, 2000. The Community Renewal Tax Relief Act of 2000 extended the first-time homebuyer credit for two additional years, through December 31, 2003. The Working Families Tax Relief Act of 2004 extended the first-time homebuyer credit for two additional years, through December 31, 2005.

President’s Budget Proposal

The President’s budget proposal extends the first-time homebuyer credit for one year, through December 31, 2006.

Analysis

The D.C. first-time homebuyer credit is intended to encourage home ownership in the District of Columbia in order to stabilize or increase its population and thus to improve its tax base. Recently, home sales in D.C. have reached record levels, and sales prices have increased. However, this has been equally true in surrounding communities. It is difficult to know the extent to which the D.C. homebuyer credit may have been a factor in the surge in home sales. According to the Treasury Department, the homeownership rate in the District of Columbia is significantly below the rate for the neighboring States and the nation as a whole. Arguably, extending the credit would enhance the District of Columbia’s ability to attract new homeowners and establish a stable residential base.

¹¹⁶ Sec. 1400C(i).

A number of policy issues are raised with respect to whether the D.C. homebuyer credit should be extended. One issue is whether it is the proper role of the Federal government to distort local housing markets by favoring the choice of home ownership in one jurisdiction over another. Favoring home ownership in one area comes at the expense of home ownership in adjacent areas. Thus, if the credit stimulates demand in the District of Columbia, this comes at the expense of demand in other portions of the relevant housing market, principally the nearby suburbs of Virginia and Maryland.

To the extent that local jurisdictions vary in their tax rates and services, individuals purchasing a home may choose to buy in the jurisdiction that offers them the combination of tax rates and services and other amenities that they desire.¹¹⁷ If a jurisdiction has a low tax rate, some might choose it on that basis. If a jurisdiction has a high tax rate but offers a high level of services, some will decide that the high tax rate is worth the services and will choose to buy in that jurisdiction. If tax rates are high but services are not correspondingly high, individuals may avoid such jurisdictions. It is in part this individual freedom to choose where to live that can promote competition in the provision of local public services, helping to assure that such services are provided at reasonable tax rates. If a jurisdiction fails at providing reasonable services at reasonable tax rates, individuals might choose to move to other jurisdictions. This may cause property values in the jurisdiction to fall and, together with taxpayer departures, may put pressure on the local government to change its behavior and improve its services. If the Federal government were to intervene in this market by encouraging the purchase of a home in one local market over another, competition among local jurisdictions in the provision of public services may be undermined.

In the above scenario, however, a dwindling tax base may make it financially difficult to improve government services. Some argue that the District of Columbia is in this position and that it needs Federal assistance to improve the District's revenue base. An alternative view is that the tax credit could take some of the pressure off the local government to make necessary improvements. By improving the local government's tax base without a commensurate improvement in government services, the Federal expenditure could encourage a slower transition to better governance.

Some argue that the credit is appropriate because a number of factors distinguish the District of Columbia from other cities or jurisdictions and that competition among the District and neighboring jurisdictions is constrained by outside factors. For example, some argue that the credit is a means of compensating the District for an artificially restricted tax base. While many residents of the suburbs work in the District and benefit from certain of its services, the Federal government precludes the imposition of a "commuter tax," which is used by some other jurisdictions to tax income earned within the jurisdiction by workers who reside elsewhere. In addition, some argue that the District has artificially reduced property, sales, and income tax revenues because the Federal government is headquartered in the District. The Federal government makes a payment to the District to compensate for the forgone revenues, but some

¹¹⁷ Other factors may also affect the choice of where to live, such as closeness to work or family members.

argue that the payment is insufficient. Some also argue that to the extent migration from the District is a result of poor services, it is not entirely within the control of the District to fix such problems, because the District government is not autonomous, but is subject to the control of Congress.

Another issue regarding the D.C. homebuyer credit is how effectively it achieves its objective. Several factors might diminish its effectiveness. First, the \$5,000 will not reduce the net cost of homes by \$5,000. Some of the \$5,000 is likely to be captured by sellers, as eligible buyers entering the market with effectively an additional \$5,000 to spend will push prices to levels higher than would otherwise attain. If the supply of homes for sale is relatively fixed, and potential buyers relatively plentiful, then the credit will largely evaporate into sellers' hands through higher prices for homes.

A second reason the credit might not be very effective at boosting the residential base of the District is that it applies to existing homes as well as any new homes that are built. Thus, the family that sells its D.C. home to a credit-eligible buyer must move elsewhere. To the extent that they sell in order to move outside of the District of Columbia, there is no gain in D.C. residences. And, to the extent that the credit caused home prices to rise, the credit can be seen as an encouragement to sell a home in the District as much as an encouragement to buy.

B. New York Liberty Zone

1. New York Liberty Zone advance refundings

Present 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 (sec. 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.” The term “private person” includes the Federal Government and all other individuals and entities other than States or local governments.

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 2005, these annual volume limits are equal to the greater of \$80 per resident of the State or \$239 million.

The Code also contains different rules for “current” as opposed to “advance” refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.¹¹⁸

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.¹¹⁹ Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.¹²⁰

New York Liberty Zone bonds

Tax-exempt financing is allowed for qualified New York Liberty Bonds issued during calendar years before January 1, 2010. An aggregate limit of \$8 billion of tax-exempt private

¹¹⁸ Sec. 149(d)(5).

¹¹⁹ Sec. 149(d)(3). 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.

¹²⁰ Sec. 149(d)(2).

activity bonds to finance the construction and rehabilitation of nonresidential real property¹²¹ and residential rental real property¹²² in a designated “Liberty Zone” (the “Zone”) of New York City is allowed. Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,¹²³ 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 these bonds authorized 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 bill.

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 \$2 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.¹²⁴ 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.

Certain bonds outstanding on September 11, 2001, used to fund facilities located in New York City are permitted one additional advance refunding through December 31, 2005. In addition to satisfying other requirements, the bond refunded must be (1) a State or local bond that is a general obligation of New York City, (2) a State or local bond issued by the New York Municipal Water Finance Authority, the Metropolitan Transportation Authority of the City of New York, or the Municipal Assistance Corporation or (3) a qualified 501(c)(3) bond which is a qualified hospital bond issued by or on behalf of the State of New York or the City of New York. The maximum amount of advance refunding bonds is \$9 billion.

¹²¹ 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.

¹²² 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.

¹²³ Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.

¹²⁴ Public utility property and residential property located outside the Zone cannot be financed with the bonds.

Legislative History

The Job Creation and Worker Assistance Act of 2002 authorized the issuance of Liberty Zone bonds and an additional advance refunding with respect to bonds financing certain facilities located in New York City before January 1, 2005.¹²⁵ The Working Families Tax Relief Act of 2004 extended the authority to issue Liberty Zone bonds through December 31, 2009 and the additional advance refunding authority through December 31, 2005.¹²⁶

President's Budget Proposal

No proposal.

Analysis

The New York Liberty Zone provisions, including authority to issue an additional advance refunding of certain bonds, were enacted to aid the City of New York's economic recovery from the terrorist attacks of September 11, 2001. Proponents of extending the authority to issue additional advance refunding bonds argue that additional time is necessary to fully utilize the bond authority and complete the recovery of New York City. Opponents argue that the New York Liberty Zone provisions were intended as a one-time measure to address the extraordinary circumstances of September 11, 2001. Some also may argue that the additional advance refunding authority does not provide an effective mechanism for assisting the City of New York's recovery efforts because the permitted additional advance refundings, unlike New York Liberty Bonds generally, are not limited to bonds financing facilities within the Zone. More generally, advance refundings are inefficient because they result in multiple issues of bonds outstanding simultaneously for a single activity. On the other hand, the additional advance refunding authority allows certain New York issuers to reduce their debt service payments, thus, improving revenue flows that may be used to assist with New York City's recovery efforts.

2. Tax incentives for investment in the New York Liberty Zone

Present Law

In general

Present law provides several incentives for taxpayers to invest in the area of New York City most heavily impacted by the terrorist attacks on September 11, 2001, and to assist taxpayers whose property was destroyed by those attacks. These incentives include a special depreciation allowance, an increase in expensing under section 179, a reduced depreciable life for certain leasehold improvements, and an extended replacement period for certain property that

¹²⁵ Pub. L. No. 107-147, sec. 301(a) (2002).

¹²⁶ Pub. L. No. 108-311, sec. 309(b) and (c) (2004).

was involuntarily converted as a result of the terrorist attacks. These incentives are generally available with respect to property located within the New York Liberty Zone (“NYLZ”).¹²⁷

New York Liberty Zone special depreciation allowance

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

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.¹²⁸ The basis of the property and the depreciation allowances in the year of purchase 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 the Modified Accelerated Cost Recovery System (“MACRS”)¹²⁹ apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property¹³⁰ and, (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30% additional first-year depreciation). Second, substantially all of the use of such property must be in the

¹²⁷ The “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.

¹²⁸ 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.

¹²⁹ 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.

¹³⁰ Qualified NYLZ leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as “qualified NYLZ leasehold improvement property” may be eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

NYLZ. Third, the original use¹³¹ of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001.¹³² Finally, the property must be acquired by purchase¹³³ by the taxpayer 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 acquisition of such property was in effect before September 11, 2001.¹³⁴

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

¹³¹ Thus, used property may constitute qualified property so long as it has not previously been used within the NYLZ. 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.

¹³² 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.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), 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 taxpayer not earlier than the date of such sale.

¹³³ For purposes of this provision, purchase is defined under section 179(d).

¹³⁴ Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

31, 2006¹³⁵ (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.

New York Liberty Zone five-year recovery period for depreciation of certain leasehold improvements

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.¹³⁶ This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.¹³⁷ If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service.¹³⁸

Depreciation of New York Liberty Zone leasehold improvements

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001 and before January 1, 2007 (and not subject to a binding

¹³⁵ In the case of qualified nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2009.

¹³⁶ Sec. 168(i)(8). 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.

¹³⁷ Former 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. The Tax Reform Act of 1986 repealed these provisions.

¹³⁸ Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not 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 v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

contract on September 10, 2001) in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a 9-year recovery period.

New York Liberty Zone increase in expensing under section 179

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. For taxable years beginning in 2003 through 2007, a taxpayer may deduct up to \$100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property for this purpose is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation.

For taxable years beginning in 2008 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

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

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased 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.

Qualifying property for purposes of the NYLZ provision means section 179 property¹³⁹ 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 NYLZ in the active conduct of a trade or business by the taxpayer in the zone, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.¹⁴⁰

¹³⁹ As defined in section 179(d)(1).

¹⁴⁰ See Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (May 20, 2002), for procedures on claiming the increased sec. 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ 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.

The provision is effective for property placed in service after September 10, 2001 and before January 1, 2007.

New York Liberty Zone extension of replacement period for nonrecognition of gain

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 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.¹⁴¹ 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.¹⁴²

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ 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.

Legislative History

The incentives for investment in NYLZ property and the extended replacement period for NYLZ property involuntarily converted as a result of the September 11, 2001 terrorist attacks were enacted as part of The Jobs Creation and Worker Assistance Act of 2002 (“JCWAA”).¹⁴³

In 2003, the Senate amendment to H.R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003, would have permitted property purchased by another member of the taxpayer’s

¹⁴¹ Section 1033(a)(2)(B).

¹⁴² Section 1033(g)(4).

¹⁴³ Pub. Law No. 107-147, sec. 301 (2002).

affiliated group (in lieu of the taxpayer) to be treated as replacement property for purposes of the provision.¹⁴⁴ The provision was not included in the conference agreement.¹⁴⁵

President's Budget Proposal

The Administration has indicated that some of the tax benefits of the NYLZ legislation likely will not be usable in the form in which they were originally provided. Accordingly, the Administration has proposed to repeal the provisions as part of an overall proposal to restructure the New York City assistance program. The repeal would be effective on the date of enactment, such that the extended replacement period for involuntarily converted NYLZ property would end on the earlier of (1) the date of enactment or (2) the last day of the five-year period specified in JCWAA.

Analysis

The NYLZ incentive provisions were intended as a one-time measure to encourage investment in the area of New York City most heavily impacted by the terrorist attacks on September 11, 2001, and to assist taxpayers whose property was destroyed by those attacks.

Generally, the accelerated depreciation and expensing provisions for NYLZ property create an incentive for taxpayers to invest in NYLZ property by reducing the present value after-tax cost of investment, which in turn increases the return on that investment. Likewise, the extended replacement period provision provides an opportunity for gain deferral if the taxpayer invests in property in New York City during the extended replacement period, indirectly reducing the cost of the New York City investment relative to a similar investment outside of New York City. However, the effectiveness of the NYLZ incentives may not yet be determinable because insufficient time has passed since they were enacted.

¹⁴⁴ The affiliated group rule would have applied only with respect to the replacement of NYLZ property.

¹⁴⁵ H.R. Conf. Rep. No. 108-126, at 220-221 (2003).

C. Qualified Zone Academy Bonds

Present 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 (sec. 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” (sec. 1397E). A total of \$400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2005. 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.

Unlike traditional State and local bonds which pay interest, a taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. 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. 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.

Legislative History

The authority to issue qualified zone academy bonds was enacted by the Taxpayer Relief Act of 1997.¹⁴⁶ Initially, qualified zone academy bonds were authorized to be issued in 1998 and 1999. The Tax Relief Extension Act of 1999 extended authority through 2001.¹⁴⁷ The Job Creation and Worker Assistance Act of 2002 extended issuance authority through 2003.¹⁴⁸ The Working Families Tax Relief Act of 2004 generally extended the authority to issue qualified zone academy bonds through 2005.¹⁴⁹

President's Budget Proposal

The proposal authorizes issuance of up to \$400 million of qualified zone academy bonds annually in calendar years 2006 and 2007. For qualified zone academy bonds issued after the date of enactment, the proposal requires issuers to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

Effective date.—The provision is effective generally for obligations issued after the date of enactment.

Analysis

Policy issues

Extending authority to issue qualified zone academy bonds subsidizes a portion of the costs of new investment in public school infrastructure and, in certain qualified areas, equipment and teacher training. By subsidizing such costs, it is possible that additional investment will take place relative to investment that would take place in the absence of the subsidy. If no additional investment takes place than would otherwise, the subsidy merely represents a transfer of funds from the Federal Government to States and local governments. This would enable States and local governments to spend the savings on other government functions or to reduce taxes.¹⁵⁰ In this event, the stated objective of the provision would not be achieved.

¹⁴⁶ Pub. L. No. 105-34 (1997).

¹⁴⁷ Pub. L. No. 106-170, sec. 509(a) (1999).

¹⁴⁸ Pub. L. No. 107-147, sec. 608(a) (2002).

¹⁴⁹ Pub. L. No. 108-311, sec. 304(a) (2004).

¹⁵⁰ Most economic studies have found that when additional funding is made available to localities from outside sources, there is indeed an increase in public spending (this is known as the “fly-paper” effect, as the funding tends to “stick” where it is applied). The additional spending is not dollar for dollar, however, implying that there is some reduction of local taxes to offset the outside funding. See Harvey Rosen, *Public Finance*, sixth ed., 2002, p. 502-503 for a discussion of this issue.

Though called a tax credit, the Federal subsidy for tax credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or local government that benefits from the bond proceeds.¹⁵¹ To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of \$100 annually. The owner of the bond that receives this payment would receive a net payment of \$100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive \$72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of \$72. In the case of tax credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of \$100 is allowed to be taken by the holder of the bond. In general, a \$100 tax credit would be worth \$100 to a taxpayer, provided that the taxpayer had at least \$100 in tax liability. However, for tax credit bonds, the \$100 credit also has to be claimed as income. Claiming an additional \$100 in income costs a taxpayer in the 28-percent tax bracket an additional \$28 in income taxes, payable to the Federal Government. With the \$100 tax credit that is ultimately claimed, the taxpayer nets \$72 on the bond. The Federal Government loses \$100 on the credit, but recoups \$28 of that by the requirement that it be included in income, for a net cost of \$72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal Government would make outlays of \$100 in interest payments, but would recoup \$28 of that in tax receipts, for a net budgetary cost of \$72, as before. Similarly, the bondholder/taxpayer would receive a taxable \$100 in interest, and would owe \$28 in taxes, for a net gain of \$72, as before. The State or local government also would be in the same situation in both cases.

Use of qualified zone academy bonds to subsidize public school investment raises some questions of administrative efficiencies and tax complexity (see below). Because potential purchasers of the zone academy bonds must educate themselves as to whether the bonds qualify for the credit, certain “information costs” are imposed on the buyer. Additionally, since the determination as to whether the bond is qualified for the credit ultimately rests with the Federal Government, further risk is imposed on the investor. These information costs and other risks serve to increase the credit rate and hence the costs to the Federal Government for a given level of support to the zone academies. For these reasons, and the fact that tax credit bonds will be less liquid than Treasury Securities, the bonds would bear a credit rate that is equal to a measure of the yield on outstanding corporate bonds.

Inefficiency in the program and, thus, arguments against extension or for modification to the program, also can be attributed to the fact that qualified zone academy bonds, unlike interest-bearing State and local bonds, are not subject to the arbitrage or rebate requirements of the Code. The ability to earn and retain arbitrage profits provides an incentive for issuers to issue more

¹⁵¹ This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.

bonds and to issue them earlier than necessary,¹⁵² which increases the cost of the subsidy. On the other hand, the lack of arbitrage or rebate requirements for qualified zone academy bonds subsidizes the repayment of principal on such bonds, as well as other qualified expenditures, by allowing issuers to invest proceeds at unrestricted yields and retain the earnings from such investments. Opponents to the imposition of arbitrage or rebate requirements may argue that such restrictions will decrease the amount of subsidy available to assist schools with significant needs, but limited means through which to satisfy those needs. Moreover, arbitrage or rebate requirements would add complexity by imposing a requirement not previously applied to qualified zone academy bonds.

The direct payment of interest by the Federal Government on behalf of States or localities, which was discussed above as being economically the equivalent of the credit proposal, would involve less complexity in administering the income tax, as the interest could simply be reported as any other taxable interest. Additionally, the tax credit approach implies that non-taxable entities would only be able to invest in the bonds to assist school investment through repurchase agreements or by acquiring rights to repayment of principal if a tax credit bond is stripped. In the case of a direct payment of interest, by contrast, tax-exempt organizations would be able to enjoy such benefits.

Complexity issues

A temporary extension provides some stability in the qualified zone academy bond program. Certainty that the program would continue at least temporarily, without further interruption or modification, arguably would facilitate financial planning by taxpayers during that period. The uncertainty that results from expiring provisions may adversely affect the administration of and perhaps the level of participation in such provisions. For example, a taxpayer may not be willing to devote the time and effort necessary to satisfy the complex requirements of a provision that expires shortly. Similarly, the Internal Revenue Service must make difficult decisions about the allocation of its limited resources between permanent and expiring tax provisions.

Some argue that a permanent or long-term extension is necessary to encourage optimal participation among potential qualified zone academy bond issuers. Others respond that the permanent repeal of expiring provisions such as the qualified zone academy bond rules that are inherently complex would provide the same level of certainty for tax planning purposes as a long-term or permanent extension, and would further reduce the overall level of complexity in the Code. A related argument is that programs such as qualified zone academy bonds would be more efficient if administered as direct expenditure programs rather than as a part of the tax law.

The proposal in the President's budget to impose reporting requirements may assist in the monitoring of the use of these bonds. On the other hand, it will add to complexity in that it

¹⁵² The Treasury Department issued proposed regulations on March 26, 2004 that would require issuers of qualified zone academy bonds to spend proceeds with due diligence. 69 CFR 15747 (March 26, 2004).

imposes a requirement not previously applied to qualified zone academy bonds. In addition, the proposal increases the paperwork burden on issuers in that forms must be completed and filed with the IRS.

IV. PROVISIONS RELATING TO TAX ADMINISTRATION

A. Disclosure of Tax Information to Facilitate Combined Employment Tax Reporting

Present law

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual States. This necessitates duplication of items common to both returns. The Code permits the IRS to disclose taxpayer identity information and signatures to any agency, body, or commission of any State for the purpose of carrying out with such agency, body or commission a combined Federal and State employment tax reporting program approved by the Secretary. The Federal disclosure restrictions, safeguard requirements, and criminal penalties for unauthorized disclosure and unauthorized inspection do not apply with respect to disclosures or inspections made pursuant to this authority.

The authority for this program expires December 31, 2005.

Under section 6103(c), the IRS may disclose a taxpayer's return or return information to such person or persons as the taxpayer may designate in a request for or consent to such disclosure. Pursuant to Treasury regulations, a taxpayer's participation in a combined return filing program between the IRS and a State agency, body or commission constitutes a consent to the disclosure by the IRS to the State agency of taxpayer identity information, signature and items of common data contained on the return.¹⁵³ No disclosures may be made under this authority unless there are provisions of State law protecting the confidentiality of such items of common data.

Legislative History

The Taxpayer Relief Act of 1997 permitted implementation of a limited demonstration project to assess the feasibility and desirability of expanding combined Federal and State reporting. As enacted, it was limited to the sharing of information between the State of Montana and the IRS. The project was limited to employment tax reporting. In addition, it was limited to disclosure of the name, address, TIN, and signature of the taxpayer. The authority for the demonstration project expired on the date five years after the date of enactment (August 5, 2002).

The Working Families Tax Relief Act of 2004 reinstated and expanded to all States the authority to participate in a combined Federal and State employment tax reporting program.

President's Budget Proposal

No proposal.

¹⁵³ Treas. Reg. sec. 301.6103(c)-1(d)(2)(i). Common data means information reflected on the Federal return required by State law to be attached to or included on the State return.

Analysis

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual states. A combined employment tax program reduces the burdens on taxpayers by combining employment tax reporting on one form.

After the section 6103 authority for the demonstration program lapsed, the Department of Treasury issued regulations permitting disclosures to State agencies for purposes of combined employment tax reporting by treating participation in the program by a taxpayer as deemed consent to disclosure. Some argue that in light of the Treasury regulations, extension of the temporary statutory authority is unnecessary. On the other hand, implementation of the combined Montana-Federal employment tax reporting project was hindered because section 6103 can be interpreted to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although if that information were supplied separately to both the State and the IRS, section 6103's restrictions would not apply to the State's use of State-requested information. Having the disclosure authority contained in the Code prevents any ambiguity as to whether such disclosures are authorized and clarifies whether the restrictions of section 6103 apply.

B. Disclosure of Return Information Regarding Terrorist Activities

Present Law

In general

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term “terrorist incident, threat, or activity” is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms are defined in the USA PATRIOT Act.¹⁵⁴ In general, returns and taxpayer return information must be obtained pursuant to an *ex parte* court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate Federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2005.

Separate from the terrorist activity provisions, the IRS has the authority to make disclosures of return information to the extent necessary to apprise appropriate officers and employees of any Federal or State law enforcement agency of circumstances involving imminent danger of death or physical injury to any individual.

Disclosure of returns and return information - by *ex parte* court order

Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies

The Code permits, pursuant to an *ex parte* court order, the disclosure of returns and return information (including taxpayer return information¹⁵⁵) 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,

¹⁵⁴ 18 U.S.C. 2331.

¹⁵⁵ “Taxpayer return information” is return information that is filed with, or furnished to, the Secretary by or on behalf of the taxpayer to whom such return information relates.

threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the *ex parte* court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that: (1) there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and (2) the return or return information is sought exclusively for the use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

Special rule for *ex parte* court ordered disclosure initiated by the IRS

If the Secretary of 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. The information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary 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 by *ex parte* court order

Disclosure by the IRS without a request

The Code permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as taxpayer return information for this purpose, and may be disclosed under this authority.

Disclosure upon written request of a Federal law enforcement agency

The Code permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. A taxpayer's identity is not treated as taxpayer return information for this purpose and may be disclosed under this authority. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Code permits the head of a Federal law enforcement agency to redisclose return information received, in response to the written request described above, 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) 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 limited to use by such officers and employees in such investigation, collection, or analysis. A taxpayer's identity is not treated as taxpayer return information for this purpose and may be disclosed under this authority.

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.

Legislative History

The terrorist activity disclosure provisions were added to the Code by the Victims of Terrorism Tax Relief Act of 2001 (Pub. L. 107-134). Authority for making disclosures under this provision lapsed on January 1, 2004. The Working Families Tax Relief Act of 2004 (Pub. L.

No. 108-311) restored the authority for disclosures made on or after October 4, 2004, through December 31, 2005.

President's Budget Proposal

The proposal extends the disclosure authority relating to terrorist activities. Under the proposal, no disclosures can be made after December 31, 2006.

Effective date.—The proposal is effective for disclosures on or after the date of enactment.

Analysis

The temporary nature of the present-law provision introduces a degree of uncertainty regarding the disclosure of return information relating to terrorist activities, i.e., whether the provision will be the subject of further extensions. There has been no study of the effectiveness of the provisions.

According to IRS accountings of disclosures made under the authority of the provisions in calendar year 2002, the IRS reported 39 disclosures to the Federal Bureau of Investigation under the terrorist activity provisions governing IRS-initiated disclosures to Federal law enforcement.¹⁵⁶ However, the IRS used its authority to make disclosures in emergency circumstances to make an additional 12,236 disclosures to the FBI. The IRS made 25 disclosures to the Department of Justice for purposes of preparing an application for an *ex parte* court order to permit the IRS to initiate an affirmative disclosure of returns and return information. Pursuant to the *ex parte* court order authority, 2,215 disclosures were made to U.S. Attorneys in calendar year 2002. The IRS did not report any terrorist activity disclosures to Federal intelligence agencies, nor did it report any disclosures in response to requests from Federal law enforcement agencies for calendar year 2002.

For calendar year 2003, 1,626 disclosures were made under the terrorist activity provisions governing IRS disclosures to Federal law enforcement. Under the *ex parte* court order authority, 1,724 disclosures were made to U.S. Attorneys in calendar year 2003. The IRS did not report any disclosures to Federal intelligence agencies or in response to requests from Federal law enforcement agencies for calendar year 2003.¹⁵⁷ This limited usage could be an indication that further extension of the provision is not warranted. On the other hand, this may not be a significant number of disclosures to evaluate the effectiveness of the provision. An additional temporary extension provides additional time to evaluate the effectiveness of the provision and whether any modifications need to be implemented to enhance the provision.

¹⁵⁶ Joint Committee on Taxation, *Revised Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(c) for Calendar Year 2002* (JCX-29-04), April 6, 2004.

¹⁵⁷ Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2003* (JCX-30-04), April 6, 2004.

Some argue that the terrorist activity disclosure provisions are duplicative provisions that were already in place for emergency disclosures and for use in criminal investigations. As noted above, the IRS used its emergency disclosure authorization to make disclosures to the Federal Bureau of Investigation concerning terrorist activity. However, the emergency disclosure authorization is to be used under circumstances involving an imminent danger of death or physical injury. In the case of terrorist activity, it may not be clear whether the danger is “imminent”, which could lead to the misapplication of the emergency authority and uncertainty as to whether a particular disclosure is authorized. Thus, the existence of a specific disclosure provision for terrorist activity information provides clear authority and direction for making disclosures to combat terrorism.

The requirements for disclosure of terrorist activity information are not as stringent as those required for criminal investigations. For example, the granting of an *ex parte* order relating to terrorist activities does not require a finding that there is reasonable cause to believe that a specific criminal act has been committed. In cases involving terrorist activity the judge or magistrate needs to determine that there is reasonable cause to believe that the return or return information may be relevant to a matter relating to such terrorist incident, threat or activity. In addition, unlike the requirements for criminal investigations, the judge or magistrate does not need to find that the information cannot be reasonably obtained from another source before granting the request for an *ex parte* order for disclosure relating to terrorist activity. Some argue that the less stringent requirements facilitate a proactive approach to combating terrorism.

C. Disclosure of Return Information to Carry Out Income Contingent Repayment of Student loans

Present Law

Income-contingent loan verification program

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.¹⁵⁸ An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.¹⁵⁹ The Department of Education disclosure authority is scheduled to expire after December 31, 2005.¹⁶⁰

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.¹⁶¹ Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather than under the specific exception.¹⁶² The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.¹⁶³

Verifying financial aid applications

The Higher Education Act of 1998 ("Higher Education Act") authorized the Department of Education to confirm with the Internal Revenue Service four discrete items of return information for the purposes of verifying student aid applications.¹⁶⁴ The Higher Education Act, however, did not amend the Code to permit disclosure for this purpose. Therefore, the disclosure provided by the Higher Education Act may not be made unless the taxpayer consents to the disclosure under section 6103(c).

¹⁵⁸ Sec. 6103.

¹⁵⁹ Sec. 6103(l)(13).

¹⁶⁰ Pub. L. No. 108-311 (2004).

¹⁶¹ Sec. 6103(c).

¹⁶² Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (October 2000) at 91.

¹⁶³ Department of Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (February 2003), p. 133.

¹⁶⁴ Pub. L. No. 105-244, sec. 483 (1998).

The financial aid application is submitted to the Department of Education and is then given to a contractor for processing. Based on the information given, the contractor calculates an expected family contribution that determines the amount of aid a student will receive. All Department of Education financial aid is disbursed directly through schools or various lenders.

The Department of Education requires schools to verify the financial aid information of 30 percent of the applicants. The applicants must furnish a copy of their tax returns. The applicants are not required to obtain copies of tax returns from the IRS or to produce certified copies, and the returns supplied by applicants to the Department of Education are not matched with the returns filed with the IRS. If the information reflected on the student's copy of the tax return does not match the information on the financial aid application, the school requires corrective action to be taken before a student receives the appropriate aid.

The Office of Inspector General of the Department of Education has reported that, because many applicants are reporting incorrect information on their financial aid applications, erroneous overpayments of Federal Pell grants have resulted.

Overpayments of Pell grants and defaulted student loans

For purposes of locating a taxpayer to collect an overpayment of a Federal Pell grant or to collect payments on a defaulted loan, the Internal Revenue Service may disclose the taxpayer's mailing address to the Department of Education.¹⁶⁵ To assist in locating the defaulting taxpayer, the Department of Education may redisclose the mailing address to the officers, employees and agents of certain lenders, States, nonprofit agencies, and educational institutions whose duties relate to the collection of student loans.¹⁶⁶

Safeguard procedures and recordkeeping

Federal and State agencies that receive returns and return information are required to maintain a standardized system of permanent records on the use and disclosure of that information.¹⁶⁷ Maintaining such records is a prerequisite to obtaining and continuing to obtain returns and return information. Such agencies must also establish procedures satisfactory to the IRS for safeguarding the information it receives. The IRS must also file annual reports with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation regarding procedures and safeguards followed by recipients of return and return information.¹⁶⁸

¹⁶⁵ Sec. 6103(m)(4).

¹⁶⁶ *Id.*

¹⁶⁷ Sec. 6103(p)(4).

¹⁶⁸ Sec. 6103(p)(5).

Legislative History

The disclosure of return information to carry out the income contingent repayment of student loans was first enacted on a temporary basis in the “Omnibus Budget Reconciliation Act of 1993”¹⁶⁹ and was scheduled to expire on September 30, 1998. The provision was enacted on a temporary basis because the Committee was concerned about the increasing number of requests for disclosure of confidential tax information for nontax purposes and the effect of such disclosure on voluntary taxpayer compliance.¹⁷⁰ The “Tax and Trade Relief Extension Act of 1998”¹⁷¹ extended the disclosure authority again on a temporary basis for an additional five years through September 30, 2003. The “Temporary Assistance for Needy Families Act of 2003”¹⁷² extended the disclosure authority through December 31, 2004. The “Working Families Tax Relief Act of 2004”¹⁷³ extended the disclosure authority an additional year through December 31, 2005.

President’s Budget Proposal

The President’s budget proposal allows the disclosure to the Department of Education and its contractors of the adjusted gross income, filing status, total earnings from employment, Federal income tax liability, type of return filed and taxpayer identity information for the financial aid applicant or of the applicant’s parents (if the applicant is a dependent) or spouse (if married). Pursuant to the President’s budget proposal, the Department of Education could use the information not only for establishing a loan repayment amount but also for verifying items reported by student financial aid applicants and their parents.

The President’s budget proposal allows the Department of Education to use contractors to process the information disclosed to the Department of Education, eliminating the need for consents. It is understood that the proposal imposes the present-law safeguards applicable to disclosures to Federal and State agencies on disclosures to the Department of Education and its contractors. Similar proposals were contained in the President’s fiscal year 2003, 2004 and 2005 budget proposals.

Effective date.—The proposal is effective with respect to disclosures made after the date of enactment.

¹⁶⁹ Pub. L. No. 103-66 (1993).

¹⁷⁰ H.R. Rept. 103-111 (1993).

¹⁷¹ Pub. L. No. 105-277 (1998).

¹⁷² Pub. L. No. 108-89 (2003).

¹⁷³ Pub. L. No. 108-311 (2004).

Analysis

Income contingent loan verification program

Currently the Department of Education uses consents to obtain tax information for purposes of its income contingent loan verification program, and does not rely on the statutory authority to receive that information without consent. The IRS processes over 100,000 consents for this program. Some might argue that since the specific statutory authority is not being used, it should not be extended.

Verifying financial aid applications

Congress has expressed a concern about the increasing number of requests for the disclosure of confidential tax information for nontax purposes and the effect of such disclosures on voluntary taxpayer compliance.¹⁷⁴ Some might argue that consensual disclosure of return information, in which the taxpayer knowingly consents to the disclosure of his or her return information (“consents”), is less likely to adversely impact taxpayer compliance than adding a nonconsensual provision for the disclosure of taxpayer information. Since the IRS is already processing consents for the Department of Education, some would argue that the current practice simply could be extended to financial aid applications.¹⁷⁵ On the other hand, some might argue that because present law does not impose restrictions on redisclosure of return information obtained by consent, the proposal, which imposes such restrictions, would be preferable.

Critics might argue that the disclosure of sensitive return information of millions¹⁷⁶ of taxpayers to identify the abuse of a few does not strike the appropriate balance between the need to know and the right to privacy. On the other hand, some might argue that since this financial information is already required to be submitted as part of the financial aid form, the infringement on taxpayer privacy is minimal.

¹⁷⁴ S. Prt. No. 103-37 at 54 (1993).

¹⁷⁵ In its study on the disclosure of return information, the Department of Treasury noted: “The burden of processing this number of consents obviously would be reduced if the consents were executed and transmitted electronically. Accordingly, the Department of Education has asked to be included in the TDS program.” Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (2000) at 92.

¹⁷⁶ The Department of Education seeks access to the return information of approximately 15 million taxpayers each year. The Department of Education receives approximately 10 million applications for student financial assistance each year. Because roughly half of the applicants are dependents, income information is needed for both the student and his or her parents. Thus, verification under this provision could apply to over 15 million taxpayers each year. It is not clear what percentage of applicants submit fraudulent financial aid applications. *Id.*

Contractors

The Administration's proposal permits the disclosure of a taxpayer's return information to contractors and agents of the Department of Education, not just to Department of Education employees. Some might argue that the use of contractors significantly expands the risk of unauthorized disclosure, particularly when return information is used by a contractor outside of the recipient agency. The volume of taxpayer information involved under this proposal and the disclosure of millions of taxpayer records, significantly contributes to the risk of unauthorized disclosure. On the other hand, some might argue that it is appropriate to permit the disclosure of otherwise confidential tax information to contractors to ensure the correctness of Federal student aid.

Opponents of the proposal may argue that it is not clear that the IRS has the resources and computer specialists to implement and enforce the safeguards that the proposal imposes. However, proponents of the proposal argue that the proposal alleviates some of the burden on the IRS by requiring the Department of Education to monitor its contractors as a supplement to the safeguard reviews conducted by the IRS.

Burdens on IRS

In general, the Administration's proposal eases the burden on the financial aid applicant because the applicant will not be required to produce copies of their tax returns for verification of their financial aid applications. The proposal arguably provides simplification for the schools as well, because the schools will no longer be required to match the information of 30 percent of its applicants. On the other hand, the proposal tends to increase complexity for the IRS by requiring it to resolve discrepancies between tax information and income data on the financial aid application if the applicant is unable to resolve the discrepancy with the school.

D. Authority for Undercover Operations

Present Law

IRS undercover operations are exempt from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the exemption permits the IRS to “churn” the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

Legislative Background

The provision was originally enacted in The Anti-Drug Abuse Act of 1988.¹⁷⁷ The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990¹⁷⁸ to December 31, 1991.¹⁷⁹ There followed a gap of approximately four and a half years during which the provision had lapsed. In the Taxpayer Bill of Rights II,¹⁸⁰ the authority to churn funds from undercover operations was extended for five years, through 2000.¹⁸¹ The Community Renewal Tax Relief Act of 2000¹⁸² extended the authority of the IRS to “churn” the income earned from undercover operations for an additional five years, through 2005.

President’s Budget Proposal

The President’s Budget proposes to extend this authority through December 31, 2010.

¹⁷⁷ Sec. 7601(c) of Pub. L. 100-690 (Nov. 18, 1988).

¹⁷⁸ Sec. 3301 of Pub. L. 101-647 (Nov. 29, 1990).

¹⁷⁹ The Ways and Means Committee Report stated: “The committee believes that it is appropriate to extend this provision for two additional years, to provide additional time to evaluate its effectiveness.” Rept. 101-681, Part 2, p. 5 (September 10, 1990).

¹⁸⁰ Sec. 1205 of Pub. L. 104-168 (July 30, 1996).

¹⁸¹ The Ways and Means Committee Report stated: “Many other law enforcement agencies have churning authority. It is appropriate for IRS to have this authority as well.” Rept. 104-506, p. 47 (March 28, 1996). The Senate passed the House bill without alteration.

¹⁸² Pub. L. 106-554.

Analysis

Some believe the extension of this authority is appropriate because they believe that it assists the fight against terrorism. Some also believe that it is appropriate for IRS to have this authority because other law enforcement agencies have churning authority. Others, however, point to the four and a half year gap during which the provision had lapsed as evidence that this authority is not essential to the operation of the IRS. However, it is difficult to show what investigative opportunities were lost due to the lack of churning authority during that period. Some believe that extension is inappropriate because the provision may provide incentives to continue undercover operations for extended periods of time. IRS data for fiscal years 2002, 2003, and 2004 reveal that a total of approximately \$748,000 was churned while only \$6,700 was deposited in the general fund of the Treasury due to the cessation of undercover operations.

E. Joint Review of IRS Strategic Plans and Budget

Present Law

Under present law, the Joint Committee on Taxation (“Joint Committee”) is required to conduct a joint review of the strategic plans and budget of the IRS by June 1 of each year after 1998 and before 2004. In addition, the Joint Committee is required to hold a joint review before June 1, 2005.¹⁸³ The joint review is to be held at the call of the Chair of the Joint Committee, and is to include two members of the majority and one member of the minority from each of the Committees on Finance, Appropriations, and Homeland Security and Governmental Affairs¹⁸⁴ of the Senate and the Committees on Ways and Means, Appropriations, and Government Reform¹⁸⁵ of the House.

For years 1999 through 2003, the Joint Committee is required to provide a report to the committees included in the joint review with respect to the:

- strategic and business plans for the IRS;
- progress of the IRS in meeting its objectives;
- budget for the IRS and whether it supports its objectives;
- progress of the IRS in improving taxpayer service and compliance;
- progress of the IRS on technology modernization; and
- annual filing season.¹⁸⁶

¹⁸³ Sec. 8021(f). Joint reviews were held on May 25, 1999, May 3, 2000, May 8, 2001, May 14, 2002, and May 20, 2003. Transcripts of the joint reviews for 1999-2002 were published by the Joint Committee on Taxation as follows: *Joint Review of Strategic Plans and Budget of the Internal Revenue Service, 1999* (JCS-4-99); *Joint Review of Strategic Plans and Budget of the Internal Revenue Service, 2000* (JCS-4-00); *Joint Review of Strategic Plans and Budget of the Internal Revenue Service, 2001* (JCS-2-02); *Joint Review of Strategic Plans and Budget of the Internal Revenue Service, 2002* (JCS-4-02).

¹⁸⁴ This committee was previously named the Committee on Governmental Affairs.

¹⁸⁵ This committee was previously named the Committee on Government Reform and Oversight.

¹⁸⁶ The reports for 1999-2003 are as follows: Joint Committee on Taxation, *Report of the Joint Committee on Taxation Relating to the Internal Revenue Service as Required by the IRS Reform and Restructuring Act of 1998* (JCX-24-99), May 20, 1999; Joint Committee on Taxation, *Report of the Joint Committee on Taxation Relating to the Internal Revenue Service as Required by the IRS Reform and Restructuring Act of 1998* (JCX-46-00), April 28, 2000; Joint Committee on Taxation, *Report of the Joint Committee on Taxation Relating to the Internal Revenue Service as Required by the IRS Reform and Restructuring Act of 1998* (JCX-33-01), May 4, 2001; Joint Committee on Taxation, *Report of the Joint Committee on Taxation Relating to the Internal Revenue Service as Required by the IRS Reform and Restructuring Act of 1998* (JCX-38-02), May 20, 2002; Joint Committee on Taxation, *Report of the Joint*

With respect to the joint review that is required to occur before June 1, 2005, the Joint Committee is to report on the matters that are the subject of the joint review.

Legislative History

The requirements for a joint review and the Joint Committee report were enacted on a temporary basis as part of the Internal Revenue Service Restructuring and Reform Act of 1998.¹⁸⁷ Under that Act, joint reviews (and reports) were required for 1999-2003. The requirement for a joint review by June 1, 2005, and the changes to the required contents of the Joint Committee report were enacted as part of the Working Families Tax Relief Act of 2004.¹⁸⁸

President's Budget Proposal

No proposal.

Analysis

There are six committees of the Congress that exercise primary oversight authority over the IRS: the Committees on Ways and Means, Appropriations, and Government Reform of the House, and the Committees on Finance, Appropriations, and Homeland Security and Governmental Affairs of the Senate. While these Committees have a shared interest in IRS matters, they typically act independently and have separate hearings and make separate investigations into IRS matters. Each committee also has jurisdiction over certain issues.

The requirement for a joint review including all committees with IRS oversight jurisdiction was enacted as a result of findings by the National Commission on Restructuring the Internal Revenue Service¹⁸⁹ that the Congressional committees responsible for IRS oversight “focus on different issues that change from year to year. While the issues they address are important, there is a lack of coordinated focus on high level and strategic matters. Because the IRS tries to satisfy requests from Congress, this nonintegrated approach to oversight further blurs the ability to set strategic direction and focus on priorities.” The Congress believed that Congressional oversight of the IRS should be more coordinated and should include long-term objectives.”¹⁹⁰

Committee on Taxation Relating to the Internal Revenue Service as Required by the IRS Reform and Restructuring Act of 1998 (JCX-53-03), May 19, 2003.

¹⁸⁷ Pub. L. No. 105-206.

¹⁸⁸ Pub. L. No. 108-311.

¹⁸⁹ See *Report of the National Commission on Restructuring of the Internal Revenue Service “A Vision of a New IRS,”* June 25, 1997.

¹⁹⁰ *Id.* at 2; H.R. Rept. No. 105-364, Part I at 84.

The joint review provides the opportunity for members of the committees with jurisdiction over various IRS issues come together to discuss areas of concern. To the extent utilized, this opportunity may assist in determining the issues of common concern (as well as those where there are differences) and assist both the IRS and the Congress in setting priorities with respect to IRS matters.

In practice, the extent to which the joint review has produced such results is unclear. Each committee continues to have its own hearings with respect to the issues within the jurisdiction of the committee. Thus, the joint review may add additional burdens on IRS personnel, which may detract from carrying out its responsibilities. In considering whether to extend the requirement for a joint review, it may be appropriate to balance potential benefits, which may be difficult to measure, against the additional burdens placed on the IRS.

The changes made to the Joint Committee report by the Working Families Tax Relief Act are intended to better tailor the report to the particular topics to be addressed by the joint review. Compared to the previously-required more generalized report, a more tailored report may provide a more useful tool for the Congress in addressing the issues of most concern.