

**PRESENT LAW AND THE PRESIDENT'S FISCAL YEAR 2011  
BUDGET PROPOSALS RELATED TO SELECTED INDIVIDUAL  
INCOME TAX PROVISIONS SCHEDULED TO EXPIRE UNDER  
THE SUNSET PROVISIONS OF THE ECONOMIC GROWTH  
AND TAX RELIEF RECONCILIATION ACT OF 2001**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on July 14, 2010

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



July 12, 2010  
JCX-36-10

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## INTRODUCTION

The Committee on Finance has scheduled a public hearing on July 14, 2010, titled “The Future of Individual Tax Rates: Effects on Economic Growth and Distribution.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a summary of present law for the principal tax provisions that are subject to the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).<sup>2</sup> This document also provides a description and analysis of the President’s fiscal year 2011 budget proposals that relate to these provisions, as well as a brief description of the policy adjustments permitted under the Statutory Pay-as-You-Go Act of 2010 (“PAYGO”) related to these provisions. Several provisions of PAYGO apply only to taxpayers with income less than \$200,000 (\$250,000 for married couples filing a joint return). There is some ambiguity in the PAYGO statute with respect to the reference year for these income levels, and for purposes of this pamphlet we have assumed that those figures represent 2009 income levels, and that the amounts are indexed in future years from those levels. The final section of this pamphlet includes tables of the budget effects of the President’s proposals and the PAYGO policy adjustments, and a distribution table of the provisions of the President’s budget proposals discussed in the pamphlet.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and the President’s Fiscal Year 2011 Budget Proposals Related to Selected Individual Income Tax Provisions Scheduled to Expire Under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001* (JCX-36-10), July 12, 2010. This document can be found on the Joint Committee on Taxation website at [www.jct.gov](http://www.jct.gov).

<sup>2</sup> Pub. L. No. 107-16.

**I. SELECTED PROVISIONS SCHEDULED TO EXPIRE UNDER SUNSET  
PROVISIONS OF THE ECONOMIC GROWTH AND TAX RELIEF  
RECONCILIATION ACT OF 2001**

**A. Extend Temporary Increase in Expensing for Small Business**

**Present Law**

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions.<sup>3</sup> For taxable years beginning after 2007 and before 2011, the maximum amount that a taxpayer may expense is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 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 \$800,000.<sup>4</sup> Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.<sup>5</sup>

For taxable years beginning in 2011 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. The \$25,000 and \$200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

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<sup>3</sup> Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

<sup>4</sup> The temporary \$250,000 and \$800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, and extended for taxable years beginning in 2010 by the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147 (the “HIRE Act of 2010”).

<sup>5</sup> Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

## **Description of the President's Fiscal Year 2011 Budget Proposal**<sup>6</sup>

The proposal increases permanently the amount a taxpayer may deduct under section 179.<sup>7</sup> The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2010, is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 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 \$500,000. The \$125,000 and \$500,000 amounts are indexed for inflation.

In addition, off-the-shelf computer software is treated as qualifying property. Further, a taxpayer is permitted to make or revoke an election for a taxable year under section 179 on an amended Federal tax return for that taxable year without the consent of the Commissioner.

### **Effective Date**

The proposal is effective for taxable years beginning after 2010.

### **Analysis**

The proposal lowers the after-tax cost of capital expenditures made by businesses within a certain size range by permitting the immediate depreciation of the full amount of the capital expenditure (i.e., expensing), rather than depreciation of the expenditure over the recovery period. With a lower cost of capital, it is argued that eligible businesses will invest in more equipment and employ more workers, thus serving to stimulate economic growth among eligible businesses taxable in the United States.

Expensing of capital investments is the appropriate treatment if the policy objective is to tax consumption, because expensing effectively eliminates tax on the returns to capital investment, subject to certain assumptions.<sup>8</sup> If the objective is to tax income, then depreciation deductions should coincide with the economic depreciation of the asset to measure economic

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<sup>6</sup> The proposal includes a provision to extend the rules under section 179 in place for taxable years beginning in 2008 and 2009 to taxable years beginning in 2010. This extension was enacted as part of the HIRE Act of 2010, as noted above.

<sup>7</sup> This permanent increase is with reference to the rules that would, absent the proposal, apply to taxable years beginning after 2010.

<sup>8</sup> For example, consider an investment of \$100 that yields a \$10 return in the following year, i.e., a 10-percent pre-tax return. If the tax rate is 50 percent, expensing of the \$100 investment yields a \$50 reduction in tax liability, meaning the after-tax cost to the taxpayer for the \$100 investment is \$50. The \$10 return in the following year results in a \$5 tax, and thus a \$5 after-tax return. Thus, the after-tax return on the investment is 10 percent (5 divided by 50), the same as the pre-tax return. To fully effect consumption tax treatment, other modifications would need to be made, such as not imposing capital gains taxes with respect to sales of business equity interests and fully integrating the corporate and individual tax systems. Additionally, no business interest expense deductions could be permitted or negative effective tax rates would result. Finally, even with the changes above, any property taxes imposed at the State or local level would cause there to remain a positive effective tax rate on the return to investment.

income accurately. A depreciation system more generous than economic depreciation, but less generous than full expensing, results in an effective tax rate on the income from capital that is less than the statutory tax rate.

In addition to promoting investment, advocates of expensing assert that increased expensing eliminates depreciation recordkeeping requirements with respect to expensed property. Under the proposal, Federal income tax accounting could be simplified by increasing the portion of capital costs that are expensed in one taxable year and concomitantly reducing those that are recovered through depreciation over the recovery period. It could be argued that the simplification benefit of expensing is not fully realized, however, so long as property is partially depreciated, or so long as some but not all of the taxpayer's property that is eligible for cost recovery is expensed; the taxpayer must still keep records for that property that is subject to depreciation over a period of years.

The proposal increases the \$200,000 phaseout threshold amount that would apply for taxable years beginning after 2010 to \$500,000, which has the effect of generally permitting larger businesses to obtain the tax benefit of expensing. Some may argue that this result is inconsistent with the idea of limiting expensing to small businesses, as under the present-law provision. They might alternatively argue that in an income tax system, expanding the availability of expensing is not appropriate because it results in a less accurate measurement of economic income. On the other hand, it could be argued that there is no rationale for limiting expensing to businesses below a particular size or with capital expenditures below a certain level.

An advantage of making the increase in the expensing amounts permanent is that it reduces uncertainty with respect to the tax treatment of future investment, thus permitting taxpayers to plan capital expenditures with greater focus on the underlying economics of the investments, and less focus on the tax-motivated timing of investment. Removing tax-motivated distortions in the timing of investment may promote more efficient allocation of economic resources. On the other hand, legislative changes to the expensing rules (principally temporary increases in the amount that can be expensed) have been frequent in the past decade, and there is nothing to prevent additional legislative changes to the expensing rules, regardless of whether the current expensing rules are permanent or temporary. Additionally, to the extent that the rationale for the original increase in the amounts that may be expensed was to provide a counter-cyclical short-term economic stimulus, it can be argued that it is important that such provisions in fact be temporary. If there is uncertainty that a provision providing temporary tax relief may not ultimately be temporary, it can be argued that the stimulative effect of the provision is compromised because the taxpayer need not act within the originally specified time frame of the provision to benefit from it.

### **Statutory PAYGO**

PAYGO provides for provisions identical to those of the President's budget proposal.

## B. Marginal Individual Income Tax Rate Reductions

### Present Law

#### In general

The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>9</sup> (“EGTRRA”) created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. These provisions of EGTRRA shall cease to apply for taxable years beginning after December 31, 2010.

#### Tax rate schedules

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer’s income increases. Separate rate schedules apply based on an individual’s filing status. For 2010, the regular individual income tax rate schedules are as follows:

**Table 1.—Federal Individual Income Tax Rates for 2010**

If taxable income is:	Then income tax equals:
<i>Single Individuals</i>	
Not over \$8,375 .....	10% of the taxable income
Over \$8,375 but not over \$34,000 .....	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$82,400 .....	\$4,681.25 plus 25% of the excess over \$34,000
Over \$82,400 but not over \$171,850 .....	\$16,781.25 plus 28% of the excess over \$82,400
Over \$171,850 but not over \$373,650 .....	\$41,827.25 plus 33% of the excess over \$171,850
Over \$373,650 .....	\$108,421.25 plus 35% of the excess over \$373,650
<i>Heads of Households</i>	
Not over \$11,950 .....	10% of the taxable income
Over \$11,950 but not over \$45,550 .....	\$1,195 plus 15% of the excess over \$11,950
Over \$45,550 but not over \$117,650 .....	\$6,235 plus 25% of the excess over \$45,550
Over \$117,650 but not over \$190,550 .....	\$24,260 plus 28% of the excess over \$117,650

<sup>9</sup> Pub. L. No. 107-16.

If taxable income is:	Then income tax equals:
Over \$190,550 but not over \$373,650 .....	\$44,672 plus 33% of the excess over \$190,550
Over \$373,650 .....	\$105,095 plus 35% of the excess over \$373,650
<b><i>Married Individuals Filing Joint Returns and Surviving Spouses</i></b>	
Not over \$16,750 .....	10% of the taxable income
Over \$16,750 but not over \$68,000 .....	\$1,675 plus 15% of the excess over \$16,750
Over \$68,000 but not over \$137,300 .....	\$9,362.50 plus 25% of the excess over \$68,000
Over \$137,300 but not over \$209,250 .....	\$26,687.50 plus 28% of the excess over \$137,300
Over \$209,250 but not over \$373,650 .....	\$46,833.50 plus 33% of the excess over \$209,250
Over \$373,650 .....	\$101,085.50 plus 35% of the excess over \$373,650
<b><i>Married Individuals Filing Separate Returns</i></b>	
Not over \$8,375 .....	10% of the taxable income
Over \$8,375 but not over \$34,000 .....	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$68,650 .....	\$4,681.25 plus 25% of the excess over \$34,000
Over \$68,650 but not over \$104,625 .....	\$13,343.75 plus 28% of the excess over \$68,650
Over \$104,625 but not over \$186,825 .....	\$23,416.75 plus 33% of the excess over \$104,625
Over \$186,825 .....	\$50,542.75 plus 35% of the excess over \$186,825

For 2011, the regular individual income tax rate schedules are as follows:

**Table 2.—Federal Individual Income Tax Rates for 2011**

If taxable income is:	Then income tax equals:
<i>Single Individuals</i>	
Not over \$34,850 .....	15% of the taxable income
Over \$34,850 but not over \$84,350 .....	\$5,227.50 plus 28% of the excess over \$34,850
Over \$84,350 but not over \$176,000 .....	\$19,087.50 plus 31% of the excess over \$84,350
Over \$176,000 but not over \$382,650 .....	\$47,499 plus 36% of the excess over \$176,000
Over \$382,650 .....	\$121,893 plus 39.6% of the excess over \$382,650
<i>Heads of Households</i>	
Not over \$46,650 .....	15% of the taxable income
Over \$46,650 but not over \$120,500 .....	\$6,997.50 plus 28% of the excess over \$46,650
Over \$120,500 but not over \$195,150 .....	\$27,675.50 plus 31% of the excess over \$120,500
Over \$195,150 but not over \$382,650 .....	\$50,817 plus 36% of the excess over \$195,150
Over \$382,650 .....	\$118,317 plus 39.6% of the excess over \$382,650
<i>Married Individuals Filing Joint Returns and Surviving Spouses</i>	
Not over \$58,200 .....	15% of the taxable income
Over \$58,200 but not over \$140,600 .....	\$8,730 plus 28% of the excess over \$58,200
Over \$140,600 but not over \$214,250 .....	\$31,802 plus 31% of the excess over \$140,600
Over \$214,250 but not over \$382,650 .....	\$54,633.50 plus 36% of the excess over \$214,250
Over \$382,650 .....	\$115,257.50 plus 39.6% of the excess over \$382,650
<i>Married Individuals Filing Separate Returns</i>	
Not over \$29,100 .....	15% of the taxable income
Over \$29,100 but not over \$70,300 .....	\$4,365 plus 28% of the excess over \$29,100
Over \$70,300 but not over \$107,125 .....	\$15,901 plus 31% of the excess over \$70,300
Over \$107,125 but not over \$191,325 .....	\$27,316.75 plus 36% of the excess over \$107,125
Over \$191,325 .....	\$57,628.75 plus 39.6% of the excess over \$191,325

## **Description of the President's Fiscal Year 2011 Budget Proposal**

The proposal permanently extends the 10-percent, 15-percent, 25-percent and 28-percent individual income tax rates.<sup>10</sup> For taxable years beginning after December 31, 2010, the 33-percent rate and the 35-percent rate brackets become 36-percent and 39.6 percent, respectively.

The proposal widens the tax rate bracket for the 28-percent rate so that individuals with less than \$195,550 of taxable income in 2011 (\$200,000 of adjusted gross income ("AGI"), assuming one personal exemption and the basic standard deduction, indexed from 2009) will not be subject to the new 36-percent rate.

For married individuals filing joint returns and surviving spouses, the dollar threshold for the new 36-percent bracket is set so that married couples and surviving spouses with adjusted gross income below \$237,300 of taxable income in 2011 (\$250,000 of AGI, assuming two personal exemptions and the basic standard deduction, indexed from 2009), currently subject to the 33-percent rate, will not become subject to the new 36-percent rate.

For head of household filers, the starting point of the 36-percent bracket is set at the midpoint of the starting points for single filers and married joint filers, rounded down to the nearest \$50, or \$216,400.

A comparison of Table 3, below, with Table 2, above, illustrates proposed tax rate changes.

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<sup>10</sup> The expansion of the 15 percent rate bracket for joint filers is also discussed in Part D of this pamphlet relating to marriage penalty relief.

**Table 3.—Federal Individual Income Tax Rates for 2011 Under the President’s Proposal**

If taxable income is:	Then income tax equals:
<b><i>Single Individuals</i></b>	
Not over \$8,575 .....	10% of the taxable income
Over \$8,575 but not over \$34,850 .....	\$858 plus 15% of the excess over \$8,575
Over \$34,850 but not over \$84,350 .....	\$4,799 plus 25% of the excess over \$34,850
Over \$84,350 but not over \$195,550 .....	\$17,174 plus 28% of the excess over \$84,350
Over \$195,550 but not over \$382,650 .....	\$48,310 plus 36% of the excess over \$195,550
Over \$382,650 .....	\$115,666 plus 39.6% of the excess over \$382,650
<b><i>Heads of Households</i></b>	
Not over \$12,250 .....	10% of the taxable income
Over \$12,250 but not over \$46,650 .....	\$1,225 plus 15% of the excess over \$12,250
Over \$46,650 but not over \$120,500 .....	\$6,385 plus 25% of the excess over \$46,650
Over \$120,500 but not over \$216,400 .....	\$24,848 plus 28% of the excess over \$120,500
Over \$216,400 but not over \$382,650 .....	\$51,700 plus 36% of the excess over \$216,400
Over \$382,650 .....	\$111,550 plus 39.6% of the excess over \$382,650
<b><i>Married Individuals Filing Joint Returns and Surviving Spouses</i></b>	
Not over \$17,150 .....	10% of the taxable income
Over \$17,150 but not over \$58,200 .....	\$1,715 plus 15% of the excess over \$17,150
Over \$58,200 but not over \$140,600 .....	\$7,872 plus 25% of the excess over \$58,200
Over \$140,600 but not over \$237,300 .....	\$28,472 plus 28% of the excess over \$140,600
Over \$237,300 but not over \$382,650 .....	\$55,548 plus 36% of the excess over \$237,300
Over \$382,650 .....	\$107,874 plus 39.6% of the excess over \$382,650
<b><i>Married Individuals Filing Separate Returns</i></b>	
Not over \$8,575 .....	10% of the taxable income
Over \$8,575 but not over \$29,100 .....	\$857.50 plus 15% of the excess over \$8,575
Over \$29,100 but not over \$70,300 .....	\$3,936 plus 25% of the excess over \$29,100
Over \$70,300 but not over \$118,650 .....	\$14,236 plus 28% of the excess over \$70,300
Over \$118,650 but not over \$191,325 .....	\$27,774 plus 36% of the excess over \$118,650
Over \$191,325 .....	\$53,937 plus 39.6% of the excess over \$191,325

## Effective Date

The proposal applies to taxable years beginning after December 31, 2010.

## Analysis<sup>11</sup>

The proposal provides tax relief to a large percentage of taxpayers, which will provide incentives for these taxpayers to work, to save, and to invest and, thereby, will have a positive effect on the long-term health of the economy. The proposal also results in increased marginal tax rates on upper income taxpayers (as is provided for by the present-law sunset of EGTRRA), which will correspondingly reduce incentives for these taxpayers to work, to save, and to invest. Opponents of this latter aspect of the proposal often note that many small businesses, and a large fraction of small business income, will be adversely impacted by an increase in the top two tax rates. The staff of the Joint Committee on Taxation estimates that in 2011 just under 750,000 taxpayers with net positive business income (three percent of all taxpayers with net positive business income) will have marginal rates of 36 or 39.6 percent under the President's proposal, and that 50 percent of the approximately \$1 trillion of aggregate net positive business income will be reported on returns that have a marginal rate of 36 or 39.6 percent.<sup>12</sup> These figures for net positive business income do not imply that all of the income is from entities that might be considered "small." For example, in 2005, 12,862 S corporations and 6,658 partnerships had receipts of more than \$50 million.<sup>13</sup>

Some argue that an increase in the top two tax rates may lead to a greater disincentive to take entrepreneurial risks as the government will take a larger share of any marginal gains from successful ventures. On the other hand, proponents of the proposal observe that, despite these negative consequences, it is appropriate to allow the rates to rise for relatively few upper income taxpayers on account of pressing needs for Federal revenues, deficit reduction and distributional concerns.

Some opponents of any extension of the EGTRRA rates argue that the projections for prolonged Federal deficits should be dealt with more aggressively even if it requires allowing more of the EGTRRA tax relief to expire. They argue that the long-term economic effects of the increased Federal debt needed to support projected spending and tax relief will adversely affect

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<sup>11</sup> This doesn't include the 3.8% unearned income medicare contribution and the 0.97 additional HI tax on earned income of \$250,000 (\$200,000 on unmarried individuals).

<sup>12</sup> This analysis excludes taxpayers subject to the AMT. Business income consists of income from sole proprietorships (Schedule C); income from rental real estate, royalties, partnerships, subchapter S corporations, estates and trusts, and real estate mortgage investment conduits (Schedule E); and farm income (Schedule F), as would be reported on lines 12, 17, and 18 of the 2008 Form 1040. Not counted as "business income" is income from interest, dividends, or capital gains that may flow through certain pass-through entities but which is reported elsewhere on an individual's return.

<sup>13</sup> See, Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity*, (JCX-48-08), June 4, 2008 for selected data on the size of business entities in the United States.

the United States' long-term economic prospects. Further, they argue that the tax cuts will reduce the ability of the Federal government to pay down the public debt, fund priorities such as education and defense, and secure the future obligations of Social Security and Medicare.

### **Statutory PAYGO**

PAYGO allows for the permanent extension of the 10-percent, 25-percent, and 28-percent rate brackets. It also allows for the permanent extension of the 33-percent rate bracket, but only for individuals with AGI of \$200,000 or less for single filers and \$250,000 or less for joint filers, with those income levels indexed for inflation in subsequent years.

The President's proposal is somewhat more generous. In 2011, joint filers with taxable income between \$214,250 and \$237,300 would be subject to a 36-percent marginal rate under present law, a 33-percent marginal rate under the adjustments permitted in the PAYGO legislation, and a 28-percent marginal rate under the President's budget proposal.

## C. Child Tax Credit

### Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum amount of the credit per child is \$1,000 through 2010, and \$500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income (“modified AGI”) over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax (“AMT”). To the extent the child tax credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the “earned income” formula). EGTRRA provided, in general, that this threshold dollar amount is \$10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 set the threshold at \$3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the “alternative formula” if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer’s social security taxes exceed the taxpayer’s earned income tax credit (“EITC”). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers’ parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of

determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

### **Description of the President's Fiscal Year 2011 Budget Proposal**

The proposal permanently extends the \$1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT. The proposal also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT. The proposal permanently extends the earned income formula for determining the refundable child credit, with the earned income threshold of \$3,000, and stops indexation for inflation of the \$3,000 earnings threshold. Finally, the proposal permanently extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2010.

### **Analysis**

For years after 2010, this proposal doubles the child tax credit (from \$500 to \$1,000) to provide additional tax relief to families to help offset the costs of raising a child. Proponents embrace the original arguments made for the EGTRRA provisions as support for permanently extending the provisions. Their principal argument is that a tax credit for families with children recognizes the expense of raising children and the importance of helping families raise children. Also, they argue that credit helps mitigate work disincentives that low-income families face due to phase-out of means-tested benefits. Further, they argue that the refundable child credit should remain widely available to families regardless of the number of children (rather than only families with three or more children), and thus it is important to extend the earned income formula for determining the refundable credit. Additionally, they believe that the child credit should be allowed to offset the AMT.

Most observers recognize that dependent children affect a taxpayer's ability to pay tax, and believe that fact should be reflected in a taxpayer's tax liability. However, some opponents raise concerns over the cost of the extension. They also note that the dependent exemption, which provides tax relief to many of the same families with dependents as receive the child tax credit, is already part of the Code. In general, opponents argue that the EGTRRA sunset provisions, including the child credit provisions, should be addressed in the context of an overall reform of the tax Code that simultaneously addresses long-term revenue requirements.

Proponents argue that the ARRA expansion of the refundable child tax credit helps offset other Federal tax liabilities to reduce the overall tax burden on working families. Opponents question whether the proliferation of refundable credits unnecessarily contributes to the complexity of the tax system. Others have also expressed concern about compliance issues with respect to refundable credits. The EITC has special rules related to taxpayers who have

improperly claimed the credit in prior years, and consideration could be given to similar rules for the refundable child credit.

**Statutory PAYGO**

PAYGO provides for provisions identical to those in the President's budget proposals.

## **D. Marriage Penalty Relief and Earned Income Tax Credit Simplification**

### **Present Law**

#### **Marriage penalty**

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

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

#### **Basic standard deduction**

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

#### **Fifteen percent rate bracket**

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return.

#### **Earned income tax credit**

The earned income credit ("EITC") is a refundable tax credit available to certain lower-income individuals. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, and the number of qualifying children.

### **Description of the President's Fiscal Year 2011 Budget Proposal**

#### **Basic standard deduction**

The proposal permanently increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.

### **15 percent rate bracket**

The proposal permanently increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return. Finally, for married couples who file a joint return, the proposal permanently increases the beginning and ending points of the EITC phase-out by \$5,000.<sup>14</sup>

### **Earned income tax credit**

The proposal permanently extends certain EITC provisions adopted by EGTRRA. These include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) a simplified tie-breaking rule; (4) additional math error authority for the Internal Revenue Service; (5) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; and (6) increases in the beginning and ending points of the credit phase-out for married taxpayers.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2010.

### **Analysis**

#### **Basic standard deduction and 15-percent rate bracket**

Proponents of the extension of these provisions are concerned about the inequity that arises when two working single individuals marry and experience a tax increase solely by reason of their marriage (a “marriage penalty”). Proponents argue that the expansion of the standard deduction and the 15-percent rate bracket for married couples filing joint returns would eliminate the effects of the marriage tax penalty for most taxpayers, and alleviate the effects for others.

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the

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<sup>14</sup> The amount is indexed for inflation annually.

first \$9,350 of his earnings would be tax-free.<sup>15</sup> However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.<sup>16</sup> Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. The preponderance of economic evidence shows that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.<sup>17</sup> In addition to fairness arguments, proponents argue for continued marriage penalty relief on economic efficiency grounds.

Any attempt to address the marriage tax penalty involves the balancing of several competing principles, including equal tax treatment of married couples with equal incomes, the determination of equitable relative tax burdens of single individuals and married couples with equal incomes, the degree of progressivity of the tax system, and the goal of simplicity in compliance and administration. It is not possible to have a tax system that has a progressive rate structure, taxes married couples with equal incomes equally, and is neutral with respect to marriage. Opponents of the extension argue that it goes too far in creating marriage bonuses while attempting to alleviate marriage penalties, and imposes too high a relative tax burden on single individuals.

### **Earned income tax credit**

Large marriage penalties exist in the EITC, because the parameters of the credit are based on earned income and numbers of qualifying children and not on marital status (other than the one provision that delays the phase-out of the credit for married taxpayers). Proponents argue that extending the EGTRRA provisions are necessary for two reasons. First, they argue that the reduction in the marriage penalty for EITC filers is particularly important for this low-income population, such that credit recipients are not discouraged from marrying on account of the loss or reduction in credit that marriage could entail. Second, they believe the simplification provisions have been effective and are worth maintaining. Others respond that simplification proposals should be addressed as part of a more comprehensive reform of the credit to reduce or eliminate high error rates by tax filers.

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<sup>15</sup> As a single taxpayer, the man could claim the standard deduction of \$5,700 and one personal exemption of \$3,650 for 2010, effectively exempting the first \$9,350 of his earnings. This example ignores payroll taxes.

<sup>16</sup> This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 28 percent to 15 percent. This example does not include SECA tax, FICA tax, the 3.8% unearned income medicare contribution and the 0.9% additional HI tax on earned income of \$25,000 (\$200,000 on unmarried individuals).

<sup>17</sup> For a general discussion of legislative history and economic issues with respect to marriage penalty issues see Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax* (JCX-8-01), March 7, 2001. See Congressional Budget Office, *For Better or for Worse: Marriage and the Federal Income Tax*, June 1997, pp. 10-12, for a review of economic literature regarding labor supply issues with respect to the marriage penalty.

### **Statutory PAYGO**

PAYGO provides for provisions identical to those in the President's budget proposals.

## E. Education Incentives

### Present Law

#### **Income and wage exclusion for awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program**

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under section 117 are also excludable from wages for payroll tax purposes.<sup>18</sup>

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”).

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Under the sunset provisions of EGTRRA, the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2010.

#### **Income and wage exclusion for employer-provided educational assistance**

If certain requirements are satisfied, up to \$5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax

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<sup>18</sup> Sec. 3121(a)(20).

purposes and from wages for employment tax purposes.<sup>19</sup> This exclusion applies to both graduate and undergraduate courses.<sup>20</sup> For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

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

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.<sup>21</sup> In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

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<sup>19</sup> Secs. 127, 3121(a)(18).

<sup>20</sup> The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2010 (under EGTRRA's sunset provision).

<sup>21</sup> Sec. 132(d).

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended 10 times.<sup>22</sup> EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.<sup>23</sup>

### **Deduction for student loan interest**

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.<sup>24</sup> Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

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

The maximum allowable deduction per year is \$2,500. For 2010, the deduction is phased out ratably for single taxpayers with AGI between \$60,000 and \$75,000 and between \$120,000 and \$150,000 for married taxpayers filing a joint return. The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are: (1) increases that were made in the AGI phaseout ranges for the deduction and (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required. With the expiration of EGTRRA, the phaseout ranges will revert to a base level of

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<sup>22</sup> The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

<sup>23</sup> Treas. Reg. sec. 1.162-5.

<sup>24</sup> Sec. 221.

\$40,000 to \$55,000 (\$60,000 to \$75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

### **Coverdell education savings accounts**

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.<sup>25</sup> Annual contributions to Coverdell education savings accounts may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.<sup>26</sup> However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.<sup>27</sup>

Tax-free (including free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary education expenses.”

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible

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<sup>25</sup> Sec. 530.

<sup>26</sup> In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

<sup>27</sup> This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

educational institution on a full-time, half-time, or less than half-time basis.<sup>28</sup> Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.<sup>29</sup>

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

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

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are: (1) the increase in the contribution limit to \$2,000 from \$500; (2) the increase in the phaseout range for married taxpayers filing jointly to \$190,000-\$220,000 from \$150,000-\$160,000; (3) the expansion of qualified expenses to include elementary and secondary education expenses; (4) special age rules for special needs beneficiaries; (5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution; (6) certain rules regarding when contributions are deemed made and extending the time during which excess contributions may be returned without additional tax; (7) certain rules regarding coordination with the Hope and

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<sup>28</sup> Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

<sup>29</sup> Sec. 530(b)(2)(B).

Lifetime Learning credits; and (8) certain rules regarding coordination with qualified tuition programs.

### **Amount of governmental bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception**

To prevent State and local governments from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.<sup>30</sup> The Code also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issuers of governmental bonds issued for local governmental activities are not subject to the rebate requirement.<sup>31</sup> To qualify for this exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than \$5 million of tax-exempt governmental bonds in a calendar year.<sup>32</sup> Prior to EGTRRA, the \$5 million limit was increased to \$10 million if at least \$5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from \$5 million to \$10 million.<sup>33</sup> Thus, these governmental units may issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset.

### **Issuance of tax-exempt private activity bonds for public school facilities**

Interest on bonds that nominally are issued by State 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.”<sup>34</sup> The term “private person” includes the Federal government and all other individuals and entities other than State or local governments.

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<sup>30</sup> The exclusion from gross income for interest on State and local bonds does not apply to any arbitrage bond (sec. 103(a), (b)(2)). A bond is an arbitrage bond if it is part of an issue that violates the restrictions against investing in higher-yielding investments under section 148(a) or that fails to satisfy the requirement to rebate arbitrage earnings under section 148(f).

<sup>31</sup> Ninety-five percent or more of the net proceeds of governmental bond issue are to be used for local governmental activities of the issuer. Sec. 148(f)(4)(D).

<sup>32</sup> Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. 1.148-8(c)(1).

<sup>33</sup> Sec. 148(f)(4)(D)(vii).

<sup>34</sup> The Code provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of section 141. See secs. 103(b)(1), 141.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency.<sup>35</sup> The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

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

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

### **Description of the President's Fiscal Year 2011 Budget Proposal**

The proposal repeals the EGTRRA sunset as it applies to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts. The proposal also repeals the EGTRRA sunset as it applies to the expansion of the small government unit exception to arbitrage rebate and allowing issuance of tax-exempt private activity bonds for public school facilities. Thus, all of these tax benefits for education continue to be available after 2010.

### **Effective Date**

The proposal is effective on the date of enactment.

### **Analysis**

#### **Individual benefits**

The present-law education tax benefits for individuals that are scheduled to expire under the EGTRRA sunset provision are intended to provide taxpayers with some financial relief for

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<sup>35</sup> Sec. 142(a)(13), (k).

education expenses previously incurred (the modifications to the deduction for student loan interest), for current education expenses (the income and wage exclusion for awards under the NHSC Scholarship Program and the Armed Forces Scholarship Program and the income and wage exclusion for employer-provided educational assistance), and for future education expenses (the modifications to Coverdell education savings accounts). If these provisions are not extended, some of the tax benefits will be completely eliminated (the income and wage exclusion for awards under the NHSC Scholarship Program and the Armed Forces Scholarship Program and the income and wage exclusion for employer-provided educational assistance), while the others will be substantially narrowed (the modifications to the deduction for student loan interest and to Coverdell education savings accounts).

Some people may observe that permanently extending these provisions may lessen the financial burden of obtaining an education for a number of taxpayers. These people may further argue that there is a distinct government interest in having a well-educated populace in the United States, and, as such, it is important for the government to continue programs that encourage the development of such a populace. Other people may observe that there are already substantial nontax incentives to obtaining additional education (e.g., greater lifetime earning potential and increased job opportunities), and these incentives are sufficient to encourage individuals to obtain an appropriate level of education.

An additional argument that some people may make is that permanently extending these provisions will remove from the Code some of the considerable uncertainty inherent in provisions with a temporary existence, which may or may not be extended at some future date. In this particular case, this uncertainty may make it difficult for taxpayers to make optimal decisions today as to the total amount that they should spend on education since they cannot be certain whether tax benefits that may currently be available to them will be available to them in the future, after they have committed themselves to pursuing additional education. As a result, they may overinvest in education, on the assumption that tax benefits will be extended when, ultimately, they are not, or underinvest in education, on the assumption that tax benefits will not be extended when, ultimately, they are. One possible response to this argument is that Congress is aware of the potential for this type of uncertainty whenever it enacts temporary provisions and deems it acceptable for any of a number of possible reasons. For example, Congress may want to revisit the issue in the future, may have insufficient support for a permanent provision, or may feel that a permanent provision is too costly. A second possible response to the argument above is that permanently extending present law is not the only way to achieve certainty; certainty may also be achieved by letting the temporary provisions expire or by enacting a permanent law today that provides for something other than a mere extension of present law.

### **Bonds for public school facilities**

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. It is argued that the exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which typically require voter approval before issuance. Opponents respond that issuers have sufficient financial sophistication that the exceptions are unwarranted. Also, they argue, further exceptions from the

arbitrage rebate requirement may result in earlier and greater bond issuance by issuers to get more arbitrage profits.

Proponents of public-private partnerships to improve educational opportunities argue that the new category of private activity bonds allows public-private partnerships to reap the benefit of the implicit subsidy to capital costs provided through tax-exempt financing. Opponents may respond that expansions of allowable private activity bonds can lead to increased borrowing costs for all private activity bonds if the volume of bond issuance grows relative to available capital.

### **Statutory PAYGO**

PAYGO provides for provisions identical to those of the President's budget proposals.

**F. Other Incentives for Families and Children  
(includes extension of the adoption tax credit, employer-provided  
child care tax credit, and dependent care tax credit)**

**Present Law**

**Adoption credit and exclusion from income for employer-provided adoption assistance**

Present law for 2010 provides: (1) a maximum adoption credit of \$13,170 per eligible child (both special needs and non-special needs adoptions); and (2) a maximum exclusion of \$32,170 per eligible child (both special needs and non-special needs adoptions). These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a \$40,000 range for taxpayers with modified adjusted gross income (“modified AGI”) in excess of certain dollar levels. For 2010, the phase-out range is between \$182,520 and \$222,520. The phaseout threshold is adjusted for inflation annually, but the phaseout range remains a \$40,000 range.

For taxable years beginning after December 31, 2011, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to \$6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between \$75,000 and \$115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

**Employer-provided child care tax credit**

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

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

favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code).

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

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2010.

#### **Dependent care tax credit**

The maximum dependent care tax credit is \$1,050 (35 percent of up to \$3,000 of eligible expenses) if there is one qualifying individual, and \$2,100 (35 percent of up to \$6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each \$2,000 (or fraction thereof) of adjusted gross income above ("AGI") \$15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over \$43,000.

The level of this credit is reduced for taxable years beginning after December 31, 2010, under the EGTRRA sunset.

### **Description of the President's Fiscal Year 2011 Budget Proposal**

#### **Adoption credit and exclusion from income for employer-provided adoption assistance**

The proposal permanently extends these two tax benefits at current levels.

#### **Employer-provided child care tax credit**

The proposal permanently extends this tax benefit.

#### **Expansion of dependent care tax credit**

The proposal permanently extends the dependent care tax credit at current levels. A separate budget proposal expands the dependent care tax credit.

## **Effective Date**

The proposals all apply to taxable years beginning after December 31, 2010.

## **Analysis**

### **Adoption credit and exclusion from income for employer-provided adoption assistance**

The adoption credit and exclusion reduce the after-tax cost of adoption for eligible taxpayers. Proponents of the benefits for adoption have argued that increasing the size of both the adoption credit and exclusion and expanding the number of taxpayers who qualify for the tax benefits have encouraged more adoptions and allowed more families to afford adoption.

Some question whether the Code is the appropriate means to subsidize adoption, for reasons including whether the benefits are most appropriately targeted and whether the IRS has the ability to monitor the claims of taxpayers. They argue that such subsidization should be via direct outlay programs, perhaps administered by the States. However, while States might reasonably administer adoption programs for domestic adoptees, it is an open question whether arranging or subsidizing foreign adoptions is an appropriate State function. Some too might argue that it is not an appropriate Federal function to subsidize foreign adoptions through Federal tax credits.

Some express concern that availability of two separate tax benefits for adoptions raises horizontal equity, complexity and compliance issues. While the credit is broadly available, the exclusion applies only to those whose employers provide adoption assistance programs. Comparable tax benefits could be provided to all if the exclusion were eliminated and the credit were allowed to be claimed on any employer-provided adoption assistance. This would have the effect of treating employer-provided assistance as ordinary compensation and of treating the payment of adoption expenses as paid by the employee from ordinary compensation. The elimination of the exclusion would also simplify the treatment of adoption expenses under the Code.

### **Employer-provided child care tax credit and dependent care tax credit**

While certain tax benefits for children are not dependent on employment (the child credit and dependent exemption for example), the employer-provided child credit and dependent care tax credit are intended to subsidize child care needs related to employment.

Some question whether the Code should provide any child-related tax benefits, on the grounds that having children is a personal choice of private consumption. Others note that the future health of the economy is dependent on the productivity of the next generation of workers, who will also provide the resources that fund the current working generation's Social Security and Medicare benefits, and thus they argue that supporting families that choose to have children is an appropriate public function. Furthermore, they argue, a tax system premised on ability to pay must make allowances for the number of individuals in a tax filing unit.

A separate argument exists for child-care-related tax benefits that relate to child care expenses necessary for employment. The argument is that these child care expenses are an

expense of earning income, and thus should essentially be deductible by analogy to general business tax principles that permit deductions for expenses (such as wages paid) necessary to earn income. Furthermore, many economists would argue that a deduction for these expenses would provide income tax treatment that is comparable to the treatment provided home production of child care—i.e., the value of home production is untaxed since the Code does not impute income to the household that provides child care services. Such households are treated as if they had income imputed to them for the services provided, but coupled with a deduction for such expenses, resulting in no increase in net income. If a worker were provided similar treatment via deductibility of child care expense, his net taxable income would rise only to the extent that his compensation exceeded that of his child care expenses.

The dependent care tax credit generally provides tax benefits less valuable than those that a full deduction for child care expense would provide. The principal reason for this is that expenses eligible for the credit are limited to an amount that is substantially less than day care costs for many taxpayers. Additionally, the credit rate for some taxpayers is less than their marginal tax rate, meaning that the deduction for the expense would provide a greater benefit than does a lower-rate credit. For a taxpayer with modest daycare expenses (if, for example, a parent only needs part-time daycare), his expenses might not be limited by the caps, and if he is a low-income taxpayer, he is likely to have a marginal income tax rate below that of the credit rate. Such taxpayer thus receives a tax benefit from the credit that is more generous than a deduction for expenses would provide at his low marginal tax rate.

Arguments for the employer-provided child care tax credit are less clear, as the benefits are not broadly available. While the credit provides benefits to employees and improves the day-care options for employees whose employers utilized the credit, a tax policy rationale for subsidizing this form of employee compensation over other forms is not immediately apparent when the dependent care tax credit is available. In the absence of the credit for employer-provided child care, an employer may still choose to provide on-site day care if it provides an advantage in recruiting and retaining valued employees. The existence of the employer subsidy and the dependent care benefit arguably provides double benefits for certain taxpayers.

Finally, while many might support the idea that families with children, specifically those with child care costs related to employment earnings, should face a lower tax burden, many among this group would prefer to see a reform of the tax system that simplifies these benefits along traditional tax policy principles, rather than extending provisions set to expire.

### **Statutory PAYGO**

PAYGO provides for the permanent extension of the adoption credit and exclusion, the employer-provided child care tax credit, and the dependent care tax credit, as provided for in the President's budget proposals. A separate President's budget proposal that would expand the dependent care tax credit is not provided for under PAYGO.

## **G. Overall Limitation on Itemized Deductions and the Personal Exemption Phase-out**

### **Present Law**

#### **Overall limitation on itemized deductions (“Pease” limitation)**

Unless an individual elects to claim the standard deduction for a taxable year, the taxpayer is allowed to deduct his or her itemized deductions. Itemized deductions generally are those deductions which are not allowed in computing adjusted gross income (“AGI”). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to 2010, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers. In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer’s AGI exceeded a threshold amount which was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) repealed this overall limitation on itemized deductions with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007; (2) a two-thirds reduction in 2008, and 2009; and (3) no overall limitation on itemized deductions in 2010. Thus in 2009, for example, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by three percent of the amount of the taxpayer’s AGI in excess of \$166,800 (\$83,400 for married couples filing separate returns). Then the overall reduction in itemized deductions was phased-down to 1/3 of the full reduction amount (that is, the limitation was reduced by two-thirds).

Pursuant to the general EGTRRA sunset, the phased-in repeal of the Pease limitation sunsets and the limitation becomes fully effective again in 2011. Adjusting for inflation, the Joint Committee Staff estimates the AGI threshold would be \$171,100 for 2011.

#### **Personal exemption phase-out for certain taxpayers (“PEP”)**

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is \$3,650. This amount is indexed annually for inflation.

Prior to 2010, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by

two percent for each \$2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. (The phase-out rate was two percent for each \$1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed was phased-out over a \$122,500 range (which was not indexed for inflation), beginning at the applicable threshold.

In 2009, for example, the applicable thresholds were \$166,800 for single individuals, \$250,200 for married individuals filing a joint return and surviving spouses, \$199,950 for heads of households, and \$125,100 for married individuals filing separate returns.

EGTRRA repealed PEP with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007; (2) a two-thirds reduction in 2008, and 2009; and (3) no PEP in 2010. However, under the EGTRRA sunset, the PEP becomes fully effective again in 2011. According to Joint Committee Staff estimates the PEP thresholds for 2011 would be: (1) \$171,100 for unmarried individuals; (2) 256,700 for married couples filing joint returns; and (3) \$213,900 for heads of households.

### **Description of Administration's Fiscal Year 2011 Budget Proposal**

#### **Overall limitation on itemized deductions ("Pease" limitation)**

The proposal would modify the overall limitation on itemized deductions. Specifically, the overall limitation on itemized deductions would apply with a new AGI threshold beginning in 2011.<sup>36</sup> For 2011, the AGI threshold would be determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This 2009 dollar amount is \$200,000 (\$250,000 for joint returns). Future years would be adjusted for inflation.

#### **Personal exemption phase-out for certain taxpayers ("PEP")**

The proposal would modify the personal exemption phase-out. Specifically, the personal exemption phase-out would apply with a new AGI threshold beginning in 2011.<sup>37</sup> For 2011 the AGI threshold would be determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This dollar amount is: (1) \$200,000 for unmarried individuals; (2) \$250,000 for joint returns; and (3) \$125,000 for married couples filing separately. Future years would be adjusted for inflation.

Effective date.—The proposal applies to taxable years beginning after December 31, 2010.

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<sup>36</sup> The repeal of the overall limitation on itemized deductions for 2010 provided under present law would not be affected by this proposal.

<sup>37</sup> The repeal of the personal exemption phase-out for 2010 provided under present law would not be affected by this proposal.

## Analysis

### Overall limitation on itemized deductions (“Pease” limitation)

The general limitation on itemized deductions increases the effective marginal tax rate for affected taxpayers. This limitation reduces (subject to the 80 percent limitation) the amount of certain itemized deductions that may be claimed by an amount equal to 3 percent of each dollar of income in excess of the threshold. Thus, if a taxpayer who is above the threshold earns an additional \$1.00 of income, the taxpayer’s taxable income increases by \$1.03 because the taxpayer’s income goes up by \$1.00 and the itemized deductions are reduced by 3 cents. For a taxpayer in the 36 percent tax bracket, the increase in tax liability resulting from the \$1.00 increase in income will be \$0.37 (the \$1.03 in additional taxable income multiplied by 36 percent). Generally, the effective marginal tax rate for taxpayers subject to the limitation on itemized deductions is 3 percent higher than the statutory tax rate. That is, the taxpayer’s effective marginal tax rate equals 103 percent of the statutory marginal tax rate. However, once the taxpayer’s itemized deductions are reduced by 80 percent, the taxpayer’s effective marginal tax rate again equals his or her statutory marginal tax rate.

Some argue that the limitation on itemized deductions diminishes a taxpayer’s incentive to make charitable contributions. While there may be a psychological effect, generally there is little or no difference in the tax motivated economic incentive to give to charity for a taxpayer subject to the limitation compared to a taxpayer not subject to the limitation. This is because while the limitation operates effectively to increase the marginal tax rate on the income of affected taxpayers, the value of the tax benefit of deductibility of the charitable deduction is determined by the statutory tax rate. For taxpayers beyond the threshold, a specified dollar amount of itemized deductions are denied. The specified dollar amount is determined by the taxpayer’s income, not by the amount of itemized deductions the taxpayer claims. Hence, the value of an additional dollar contributed to charity increases by exactly one dollar times the total amount of itemized deductions that the taxpayer may claim. Because the statutory rates apply to taxable income (income after claiming permitted itemized deductions), the value of the additional contribution to charity is determined by the statutory tax rate. Economists would say that the “tax price” of giving is not altered by the limitation.<sup>38</sup>

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<sup>38</sup> This can be seen mathematically as follows. Let  $Y$  be the taxpayer’s income and  $X$  be the threshold above which the limitation on itemized deductions applies. Let  $D$  be itemized deductions and  $t$  the taxpayer’s marginal tax rate. Then the taxpayer’s total tax liability,  $T$ , is:

$$T = [Y - \{D - (.03)(Y - X)\}]t$$

or

$$T = Y[1 + (.03)]t - Dt - (.03)tX.$$

What this implies is that as the taxpayer’s income,  $Y$ , increases by \$1.00, his or her tax liability increases by  $(1.03)t$ , as noted in the text. However, if the taxpayer increases his or her itemized deductions,  $D$ , by \$1.00, his or her reduction in tax liability is  $t$  dollars. In other words, the statutory tax rate determines the value of the deduction. This algebra assumes the taxpayer is not subject to the 80-percent limitation.

Proponents of the reinstatement of the Pease limitation (as provided by the sunset provisions of EGTRRA) argue that those who are relatively well-off should be restricted in their ability to benefit from itemized deductions, and that raising more revenue from the relatively well-off is appropriate given the magnitude and growing size of the Federal deficit.

Opponents of the reinstatement of the Pease limitation argue that the overall limitation on itemized deductions is an unnecessarily complex mechanism for imposing taxes and that the “hidden” way in which the limitation raises marginal tax rates undermines respect for the tax laws. The overall limitation on itemized deductions is reflected in a 12-line worksheet. Moreover, the first line of that worksheet requires the adding up of seven line items from Schedule A of the Form 1040, and the second line requires the adding up of five line items of Schedule A of the Form 1040. The legislative history for EGTRRA states that reducing the application of the overall limitation on itemized deductions would significantly reduce complexity for affected taxpayers.

### **Personal exemption phase-out for certain taxpayers (“PEP”)**

The personal exemption phase-out would increase effective marginal tax rates for affected taxpayers. The personal exemption phase-out would operate by reducing the amount of each personal exemption that the taxpayer could claim by two percent for each \$2,500 (or portion thereof) by which the taxpayer’s income exceeded the designated threshold for his or her filing status. Thus, for a taxpayer who was subject to the personal exemption phase-out, earning an additional \$2,500 would reduce the amount of each personal exemption he or she could claim by two percent, or by \$73 in 2011 (0.02 times the \$3,650<sup>39</sup> personal exemption). The taxpayer’s additional taxable income would be equal to the \$2,500 plus the \$73 in denied exemption for each personal exemption. For a taxpayer in the 36 percent statutory marginal tax rate bracket, the effective marginal tax rate on the additional \$2,500 of income equals the statutory 36 percent plus an additional 1.05 percent (\$73 times the statutory rate of 0.36, divided by the \$2,500 in incremental income) for each personal exemption. Thus, if this taxpayer claims four personal exemptions, his or her effective marginal tax rate is 40.2 percent (the statutory 36 percent rate plus four times 1.05 percent). More generally, for 2011 a taxpayer’s effective marginal tax rate equals the taxpayer’s statutory marginal rate multiplied by one plus the product of 2.92 percentage points (the \$73 in denied personal exemption divided by the incremental \$2,500 in income) multiplied by the number of personal exemptions claimed. Thus, a taxpayer claiming four personal exemptions would have an effective marginal tax rate approximately 111.7 percent of the statutory marginal tax rate (or 40.2 percent).

Proponents of the reinstatement of the phase-out of the personal exemption (as provided by the sunset provisions of EGTRRA) argue that those who are relatively well-off should be restricted in their ability to benefit from personal exemptions, and that raising more revenue from the relatively well-off is appropriate given the magnitude and growth of the Federal deficit.

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<sup>39</sup> The \$3,650 exemption level will increase for 2011 by the as yet undetermined inflation adjustment

Opponents of the reinstatement argue that the high cost of raising children should properly be reflected at all levels of the income distribution, on the grounds that those who are relatively well-off but have no children should face a higher tax burden than those who are relatively well-off but with children, in the same manner that a couple earning \$50,000 without children is required to pay more tax than a couple earning \$50,000 with children. Opponents further argue that the personal exemption phase-out imposes excessively high effective marginal tax rates on families with children, is an unnecessarily complex mechanism for imposing income taxes, and that the “hidden” way in which the phase-out raises taxes undermines respect for tax laws.

### **Statutory PAYGO**

Statutory PAYGO provides for provisions identical to those of the Administration’s budget proposal.

## **H. Alternative Minimum Tax Relief**

### **Present Law**

Present law imposes an alternative minimum tax (“AMT”) on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual’s tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income (“AMTI”) as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual’s taxable income adjusted to take account of specified preferences and adjustments.

The exemption amounts are: (1) \$70,950 for taxable years beginning in 2009 and \$45,000 in taxable years beginning after 2009 in the case of married individuals filing a joint return and surviving spouses; (2) \$46,700 for taxable years beginning in 2009 and \$33,750 in taxable years beginning after 2009 in the case of other unmarried individuals; (3) \$35,475 for taxable years beginning in 2009 and \$22,500 in taxable years beginning after 2009 in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual’s AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2010, the nonrefundable personal credits are allowed to the extent of the full amount of the individual’s regular tax and alternative minimum tax.

For taxable years beginning after 2009, the nonrefundable personal credits (other than the child credit, the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric drive motor vehicles, the credit for alternative motor vehicles, and credit for new qualified plug-in electric drive motor vehicles) are allowed only to the extent that the individual’s regular income tax liability exceeds the individual’s tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The remaining nonrefundable

personal credits are allowed to the full extent of the individual's regular tax and alternative minimum tax.<sup>40</sup>

### **Description of the President's Fiscal Year 2011 Budget Proposal**

The proposal provides that the individual AMT exemption amounts, the thresholds for the phaseout of the exemption amounts, and the threshold amounts for the beginning of the 28-percent bracket are indexed for inflation from the levels in effect for 2009. The proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

### **Effective Date**

The proposal is effective for taxable years beginning after 2009.

### **Analysis**

Allowing the nonrefundable personal credits to offset the regular tax and alternative minimum tax, and increasing the exemption amounts, will substantially reduce the number of taxpayers affected by the AMT. Figure 1 below, shows the number of taxpayers affected by the AMT under present law, the President's budget, and PAYGO. In addition to the reduction in tax liability as a result of this change, there will be significant simplification benefits. Substantially fewer taxpayers will need to complete the alternative minimum tax form (Form 6251), and the forms and worksheets relating to the various credits can be simplified.

By permanently establishing the AMT exemption levels and ability to take nonrefundable credits against the AMT, the proposal provides greater certainty for taxpayers as to their tax obligation resulting from the AMT, in comparison to the practice over the past years of annually adjusting the exemption levels to prevent their reversion to the levels in effect prior to EGTRRA. Additionally, by indexing the AMT system for inflation, as is done in the regular tax system, the proposal prevents tax increases in real terms for the portion of one's income growth that merely accounts for inflationary growth. By doing so, the proposal substantially slows the rate of growth in the number of taxpayers subject to the AMT over time.

A number of analysts argue that the proposal does not go far enough, advocating instead the abolition of the AMT. Their argument rests on the observation that the AMT system has outlived its original purpose of requiring taxpayers engaged in substantial sheltering of income to pay at least some minimum tax. Instead, taxpayers today are mainly ensnared by the AMT as a result of their income level, payment of state and local taxes, and presence of dependents. Such analysts argue that requiring such taxpayers to calculate their liability two ways is needlessly complex and serves no discernible policy objective that the regular tax alone could not provide.

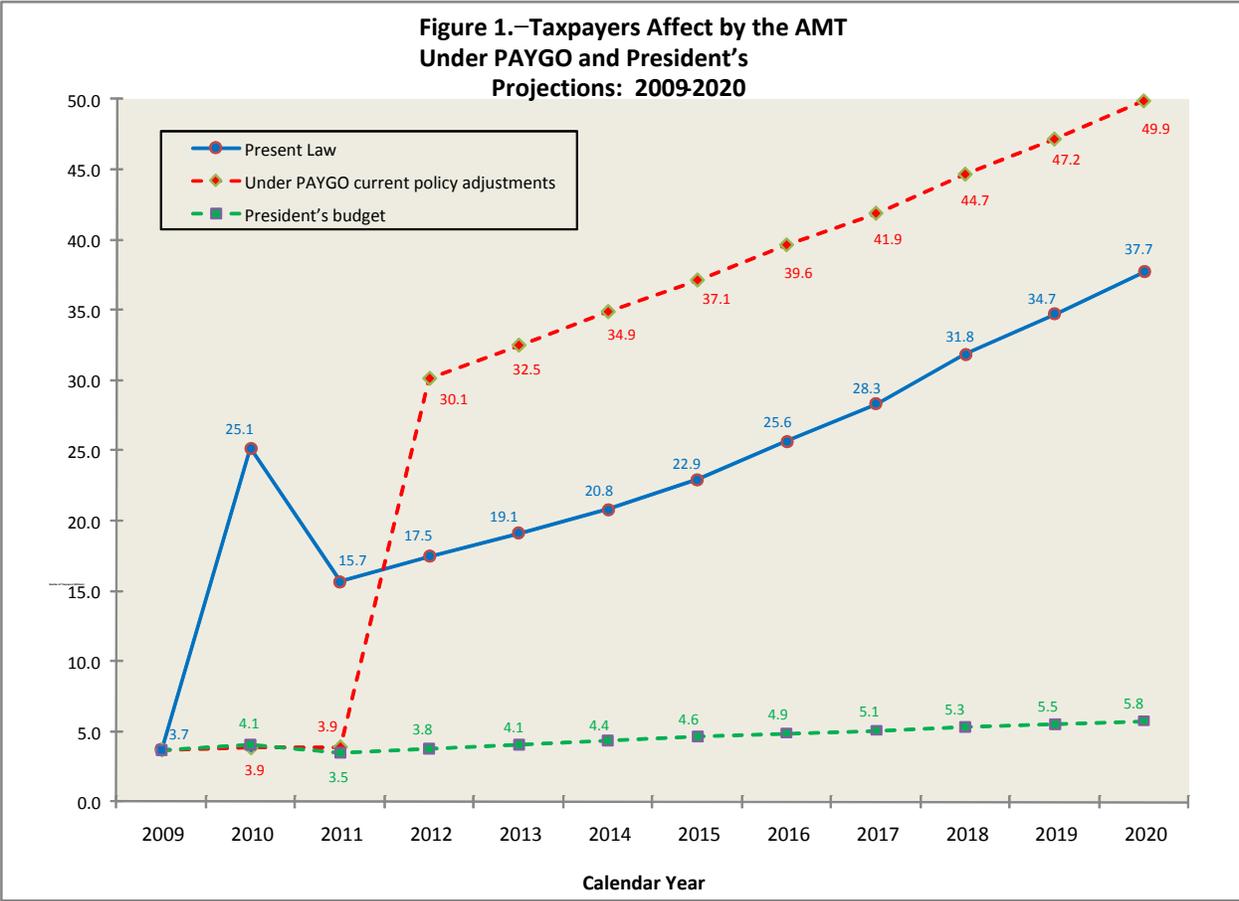
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<sup>40</sup> The rule applicable to the child credit after 2010 is subject to the EGTRRA sunset. The adoption credit is refundable in 2010 and 2011 and beginning in 2012 is nonrefundable and treated in the same manner as the child credit.

Table 4 shows the individual AMT parameters for 2009-2011 under present law, the PAYGO legislation, and the President's budget proposal. For example, the AMT exemption amount in 2010 for married individuals filing a joint return is \$45,000 under present law, \$72,450 under the adjustments permitted in the PAYGO legislation, and \$71,050 under the President's budget proposal.

**Table 4.—Projected Alternative Minimum Tax Parameters**

	<u>2009</u>	<u>2010</u>	<u>2011</u>
<i>Present Law</i>			
<u>AMT Exemption Amount</u>			
Unmarried Individual	\$46,700	\$33,750	\$33,750
Married Filing a Joint Return	\$70,950	\$45,000	\$45,000
28-Percent Bracket Threshold	\$175,000	\$175,000	\$175,000
<u>AMT Exemption Phase-out Threshold</u>			
Unmarried Individual	\$112,500	\$112,500	\$112,500
Married Filing a Joint Return	\$150,000	\$150,000	\$150,000
<i>Statutory Pay-As-You-Go Act of 2010</i>			
<u>AMT Exemption Amount</u>			
Unmarried Individual	\$46,700	\$47,450	\$47,100
Married Filing a Joint Return	\$70,950	\$72,450	\$71,750
28-Percent Bracket Threshold	\$175,000	\$175,000	\$175,000
<u>AMT Exemption Phase-out Threshold</u>			
Unmarried Individual	\$112,500	\$112,500	\$112,500
Married Filing a Joint Return	\$150,000	\$150,000	\$150,000
<i>President's Fiscal Year 2011 Budget Proposals</i>			
<u>AMT Exemption Amount</u>			
Married Individual	\$46,700	\$46,750	\$47,900
Married Filing a Joint Return	\$70,950	\$71,050	\$72,750
28-Percent Bracket Threshold	\$175,000	\$175,300	\$179,500
<u>AMT Exemption Phase-out Threshold</u>			
Unmarried Individual	\$112,500	\$112,700	\$115,400
Married Filing a Joint Return	\$150,000	\$150,250	\$153,850



**Statutory PAYGO**

PAYGO provides for only two years of AMT relief. Specifically, it provides that the exemption levels may be increased in 2010 and 2011 to hold the number of taxpayers affected by the AMT at 2008 levels (3.9 million taxpayers). PAYGO also would allow an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

## **II. ESTIMATED BUDGET EFFECTS OF THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSALS AND STATUTORY PAYGO OPTIONS**

Table 5 below shows the estimated budget effects of the Administration's budget proposals discussed in this pamphlet. Table 6 shows the estimated budget effects of the options covered under the statutory PAYGO policy. In cases where the estimated budget effects differ between the President's proposal and PAYGO for an identical provision, the reason stems from interaction with other provisions in the proposals, namely the difference in the rate structure under PAYGO versus the President's budget. Table 7, below shows a distribution of the budget effects of the President's proposals.

- Table 5 -  
ESTIMATED BUDGET EFFECTS OF STATUTORY PAYGO POLICY OPTIONS

Fiscal Years 2010 - 2020

[Billions of Dollars]

Provision	Effective	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2010-15	2010-20
<b>I. Make Permanent Certain Tax Cuts Enacted in 2001 and 2003</b>														
A. Permanently Increase the Maximum Amount and Phaseout Threshold Under Section 179 that are Scheduled to Expire After 2010.....	tyba 12/31/10	---	-2.8	-5.1	-4.5	-3.9	-2.9	-2.0	-1.3	-1.0	-1.0	-1.2	-19.2*	-25.7
B. Reductions in Individual Income Tax Rates														
1. Retain 10% bracket.....	tyba 12/31/10	---	-30.7	-44.7	-45.8	-46.8	-47.2	-47.1	-47.0	-46.7	-46.5	-46.2	-215.4	-448.7
2. Retain the 25%, the 28%, and part of the 33% income tax bracket.....	tyba 12/31/10	---	-12.5	-18.6	-19.8	-20.9	-21.6	-21.8	-22.0	-22.0	-21.9	-21.9	-93.5	-203.2
C. Extend the \$1,000 Child Tax Credit, Refundability, and AMT rules.....	tyba 12/31/10	---	-7.1	-45.5	-46.3	-46.7	-46.8	-47.1	-47.6	-48.0	-48.3	-48.6	-192.3	-432.0
D. Marriage Penalty Relief.....	tyba 12/31/10	---	-6.3	-13.5	-13.8	-13.9	-13.8	-13.5	-13.4	-13.2	-13.1	-13.0	-61.2	-127.5
E. Education Incentives [1] [2].....	generally 1/1/11	---	-0.8	-1.7	-1.7	-1.8	-1.9	-2.1	-2.3	-2.3	-2.4	-2.6	-7.9*	-19.6
F. Other Incentives for Families and Children [3].....	tyba 12/31/10	---	-0.1	-0.9	-2.4	-2.5	-2.7	-2.9	-2.9	-3.2	-3.4	-3.8	-8.7	-25.0
G. Repeal Overall Limitation on Itemized Deduction and the Personal Exemption Phaseout for Certain Taxpayers.....	tyba 12/31/10	---	-0.3	-0.7	-0.7	-0.8	-0.9	-1.0	-1.0	-1.0	-1.1	-1.1	-3.5	-8.7
<b>Total of Make Permanent Certain Tax Cuts Enacted in 2001 and 2003.....</b>		<b>---</b>	<b>-60.6</b>	<b>-130.7</b>	<b>-135.0</b>	<b>-137.3</b>	<b>-137.9</b>	<b>-137.6</b>	<b>-137.6</b>	<b>-137.5</b>	<b>-137.7</b>	<b>-138.3</b>	<b>-601.7</b>	<b>-1,290.4</b>
<b>II. Increase AMT Exemption Amount and Allow Personal Credits Against the AMT to Hold Number of Taxpayers Affected by the AMT at the Same Number Estimated to be Affected by the AMT in Tax Year 2008 (sunset 12/31/11).....</b>														
	tyba 12/31/09	-3.2	-82.7	-68.0	16.9	---	---	---	---	---	---	---	-137.0	-137.0
<b>NET TOTAL .....</b>		<b>-3.2</b>	<b>-143.3</b>	<b>-198.7</b>	<b>-118.1</b>	<b>-137.3</b>	<b>-137.9</b>	<b>-137.6</b>	<b>-137.6</b>	<b>-137.5</b>	<b>-137.7</b>	<b>-138.3</b>	<b>-738.7</b>	<b>-1,427.4</b>

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is generally assumed to be October 1, 2010.

Legend for "Effective" column: tyba = taxable years beginning after

[1] The provision that permanently extends the exclusion for undergraduate courses and graduate level courses is included in the Education Incentives line and includes the following effects:

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2010-15	2010-20
Total Revenue Effects.....	---	-0.7	-1.0	-1.0	-1.0	-1.1	-1.1	-1.2	-1.2	-1.2	-1.2	-4.7	-10.5
On-budget effects.....	---	-0.5	-0.7	-0.7	-0.7	-0.7	-0.7	-0.8	-0.8	-0.8	-0.8	-3.2	-7.1
Off-budget effects.....	---	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-1.5	-3.4

[2] Includes an extension of all education incentives subject to the EGTRRA sunset: Coverdell education savings accounts, employer provided assistance, student loan interest, tax on awards, arbitrage rebate exception for school construction bonds, and tax-exempt private activity bonds for qualified education facilities.

[3] Estimate includes extension of the adoption tax credit, employer-provided child care tax credit, and dependent care tax credit. The estimate relating to the adoption tax credit is for the extension of EGTRRA and does not include extension of refundability as enacted by H.R. 3590, the "Patient Protection and Affordable Care Act ('PPACA')."

- Table 6 -  
**ESTIMATED BUDGET EFFECTS OF CERTAIN REVENUE PROVISIONS CONTAINED IN  
THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL**

Fiscal Years 2010 - 2020

[Billions of Dollars]

Provision	Effective	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2010-15	2010-20
<b>I. Make Permanent and Modify Certain Tax Cuts Enacted in 2001 and 2003</b>														
A. Permanently Increase the Maximum Amount and Phaseout Threshold Under Section 179 that are Scheduled to Expire After 2010.....	tyba 12/31/10	---	-2.8	-5.1	-4.5	-3.9	-2.9	-2.0	-1.3	-1.0	-1.0	-1.2	-19.2 <sup>▼</sup>	-25.7
B. Reductions in Individual Income Tax Rates														
1. Retain 10% bracket.....	tyba 12/31/10	---	-30.7	-44.7	-45.8	-46.8	-47.2	-47.1	-47.0	-46.7	-46.5	-46.2	-215.4	-448.7
2. Retain the 25% income tax bracket, and retain and expand the 28% income tax bracket.....	tyba 12/31/10	---	-13.2	-19.7	-21.0	-22.3	-23.1	-23.4	-23.7	-23.8	-23.8	-23.8	-99.2	-217.7
C. Extend the \$1,000 Child Tax Credit, Refundability, and AMT rules.....	tyba 12/31/10	---	-7.1	-45.5	-46.3	-46.7	-46.8	-47.1	-47.6	-48.0	-48.3	-48.6	-192.3	-432.0
D. Marriage Penalty Relief.....	tyba 12/31/10	---	-6.2	-13.4	-13.7	-13.8	-13.7	-13.4	-13.3	-13.2	-13.0	-12.9	-42.8	-126.9
E. Education Incentives [1] [2].....	generally 1/1/11	---	-0.8	-1.7	-1.7	-1.8	-1.9	-2.1	-2.3	-2.3	-2.4	-2.6	-7.9 <sup>▼</sup>	-19.6
F. Other Incentives for Families and Children [3].....	tyba 12/31/10	---	-0.1	-0.9	-2.4	-2.5	-2.7	-2.9	-2.9	-3.2	-3.4	-3.8	-8.7	-25.0
G. Repeal Overall Limitation on Itemized Deduction and the Personal Exemption Phaseout for Certain Taxpayers.....	tyba 12/31/10	---	-0.3	-0.6	-0.7	-0.8	-0.8	-0.9	-0.9	-1.0	-1.0	-1.1	-3.3	-8.2
<b>Total of Make Permanent and Modify Certain Tax Cuts Enacted in 2001 and 2003.....</b>		<b>---</b>	<b>-61.2</b>	<b>-131.7</b>	<b>-136.1</b>	<b>-138.6</b>	<b>-139.2</b>	<b>-139.0</b>	<b>-139.1</b>	<b>-139.3</b>	<b>-139.4</b>	<b>-140.1</b>	<b>-588.8</b>	<b>-1,303.7</b>
<b>II. Index to Inflation the 2009 Parameters of the AMT as Enacted in the American Recovery and Reinvestment Act.....</b>														
	tyba 12/31/09	-3.2	-82.1	-77.1	-87.6	-98.3	-109.6	-122.5	-137.2	-153.1	-171.2	-189.6	-457.8	-1,231.4
<b>NET TOTAL .....</b>		<b>-3.2</b>	<b>-143.3</b>	<b>-208.8</b>	<b>-223.7</b>	<b>-236.9</b>	<b>-248.8</b>	<b>-261.5</b>	<b>-276.3</b>	<b>-292.4</b>	<b>-310.6</b>	<b>-329.7</b>	<b>-1,046.6</b>	<b>-2,535.1</b>

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is generally assumed to be October 1, 2010.

Legend for "Effective" column: tyba = taxable years beginning after

[1] The provision that permanently extends the exclusion for undergraduate courses and graduate level courses is included in the Education

Incentives line and includes the following effects:

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2010-15	2010-20
Total Revenue Effects.....	---	-0.7	-1.0	-1.0	-1.0	-1.1	-1.1	-1.2	-1.2	-1.2	-1.2	-4.7	-10.5
On-budget effects.....	---	-0.5	-0.7	-0.7	-0.7	-0.7	-0.7	-0.8	-0.8	-0.8	-0.8	-3.2	-7.1
Off-budget effects.....	---	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-1.5	-3.4

[2] Includes an extension of all education incentives subject to the EGTRRA sunset: Coverdell education savings accounts, employer provided assistance, student loan interest, tax on awards, arbitrage rebate exception for school construction bonds, and tax-exempt private activity bonds for qualified education facilities.

[3] Estimate includes extension of the adoption tax credit, employer-provided child care tax credit, and dependent care tax credit. The estimate relating to the adoption tax credit is for the extension of EGTRRA and does not include extension of refundability as enacted by H.R. 3590, the "Patient Protection and Affordable Care Act (PPACA)."

**TABLE 7.—DISTRIBUTIONAL EFFECTS OF SELECTED PROPOSALS  
CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2011  
BUDGET PROPOSAL (1)  
[Returns in Millions; Dollars in Billions]**

Calendar Year 2011

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)							
	All Returns		Single Filers		Joint Filers		Head of Household	
	Returns	Dollars	Returns	Dollars	Returns	Dollars	Returns	Dollars
Less than \$10,000.....	2.8	-\$1.7	0.5	-\$0.3	0.5	-\$0.4	1.8	-\$1.1
\$10,000 to \$20,000.....	6.6	-\$7.7	0.6	-\$0.6	1.8	-\$2.1	4.1	-\$5.0
\$20,000 to \$30,000.....	6.8	-\$9.3	0.3	-\$0.3	2.8	-\$4.5	3.7	-\$4.5
\$30,000 to \$40,000.....	5.9	-\$7.8	0.2	-\$0.1	3.5	-\$5.2	2.3	-\$2.4
\$40,000 to \$50,000.....	5.9	-\$5.8	1.0	-\$0.2	3.6	-\$4.0	1.3	-\$1.6
\$50,000 to \$75,000.....	17.6	-\$14.3	6.3	-\$2.4	9.5	-\$8.9	1.9	-\$2.9
\$75,000 to \$100,000.....	12.8	-\$20.3	3.1	-\$2.8	9.0	-\$15.9	0.8	-\$1.7
\$100,000 to \$200,000.....	16.3	-\$53.7	2.3	-\$4.8	13.5	-\$47.5	0.5	-\$1.4
\$200,000 to \$500,000.....	3.7	-\$23.9	0.5	-\$2.2	3.1	-\$21.5	0.1	-\$0.3
\$500,000 to \$1,000,000..	0.6	-\$3.8	0.1	-\$0.4	0.5	-\$3.3	(4)	-\$0.1
\$1,000,000 and over.....	0.3	-\$2.1	(4)	-\$0.2	0.3	-\$1.8	(4)	\$0.0
<b>Total, All Taxpayers....</b>	<b>79.4</b>	<b>-\$150.3</b>	<b>14.9</b>	<b>-\$14.2</b>	<b>48.1</b>	<b>-\$115.2</b>	<b>16.5</b>	<b>-\$20.9</b>

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

- (1) The following proposals are included: (a) reductions in individual income tax rates, (b) changes to the child tax credit, (c) marriage penalty relief, (d) incentives for families and children, (e) repeal of the limitation on itemized deductions and personal exemptions for certain taxpayers, and (f) indexing the AMT.
- (2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2009 levels.
- (3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.
- (4) Less than 50,000.