PRESENT LAW AND BACKGROUND ON FEDERAL TAX PROVISIONS RELATING TO RETIREMENT SAVINGS INCENTIVES, HEALTH AND LONG-TERM CARE, AND ESTATE AND GIFT TAXES

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 16, 1999

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INTRODUCTION

The House Committee on Ways and Means has announced a series of public hearings on proposals to reduce the tax burden on individuals and businesses. The first day of the series, scheduled for June 16, 1999, will focus on retirement and health security, and will include a review of proposals relating to retirement savings incentives, health and long-term care incentives, and estate and gift tax relief.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and background information relating to tax incentives for retirement savings (Part One), health and long-term care (Part Two), and estate and gift taxes (Part Three).

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background on Federal Tax Provisions Relating to Retirement Savings Incentives, Health and Long-Term Care, and Estate and Gift Taxes* (JCX-29-99), June 15, 1999.

PART ONE: PRESENT LAW AND BACKGROUND RELATING TO TAX INCENTIVES FOR RETIREMENT SAVINGS

I. PRESENT LAW

A. In General

Dividend and interest income generally is taxable under present law. However, present law also contains a number of provisions which permit individuals to save on a tax-favored basis. These include provisions relating to individual retirement arrangements, tax-qualified retirement plans and similar employer-sponsored arrangements, annuity contracts, life insurance, medical savings accounts, and various education savings vehicles.

B. Individual Retirement Arrangements ("IRAs")

In general

There are two different types of IRAs under present law: (1) "traditional" IRAs, to which both deductible and nondeductible contributions can be made, and (2) Roth IRAs. The economic benefits of making deductible contributions to a traditional IRA and contributions to a Roth IRA are similar,[2] although the rules applicable to each type of IRA contribution vary.

Deductible IRA contributions

Under present law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or the individual's compensation if the individual and the individual's spouse are not active participants in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year.

The AGI phase-out limits for a single individual who is an active participant in an employer-sponsored retirement plan are as follows: for 1999, $31,000 to $41,000; for 2000, 2001 and 2002, the limits increase by $1,000 each year, so that the limits by 2002 are $34,000 to $44,000; for 2003, $40,000 to $50,000; for 2004, $45,000 to $55,000; and for 2005 and thereafter, $50,000 to $60,000.

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[2] For a detailed comparison of Roth IRAs and deductible IRAs, see Joint Committee on Taxation *Description and Analysis of Tax Proposals Relating to Individual Savings and IRAs* (JCS-2-97), March 3, 1997.

The AGI phase-out limits for a married individual filing a joint return who is an active participant in an employer-sponsored plan are as follows: for 1999, $51,000 to $61,000; for 2000, 2001 and 2002, the limits increase by $1,000 each year, so that the limits by 2002 are $54,000 to $64,000; for 2003, $60,000 to $70,000; for 2004, $65,000 to $75,000; for 2005, $70,000 to $80,000; for 2006, $75,000 to $85,000; and for 2007 and thereafter, $80,000 to $90,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a deductible or nondeductible IRA into an Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over 4 years.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies).[3] The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

Nondeductible IRA contributions

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible As described above, distributions from a traditional IRA are includible in income and subject to the 10-percent early withdrawal tax, except to the extent the distribution is attributable to nondeductible contributions.

Legislative history

The IRA provisions were originally enacted in the Employee Retirement Income Security Act of 1974 ("ERISA"). Individuals who were active participants in an employer-sponsored retirement plan were not permitted to make contributions to an IRA. The limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual's compensation for the year, or (2) $1,500.

The Economic Recovery Tax Act of 1981 increased the deduction limit for contributions to IRAs and removed the restriction on IRA contributions by active participants in employer-sponsored retirement plans. Beginning in 1982, the deduction for IRA contributions was generally the lesser of (1) 100 percent of the individual's compensation, or (2) $2,000. An individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer-sponsored retirement plan.

The Tax Reform Act of 1986 ("1986 Act") added restrictions on deductible IRA contributions if the individual (or the individual's spouse) was an active participant in employer-sponsored retirement plan. For years 1987 through 1997, if a single taxpayer or either spouse (in the case of a married couple) was an active participant in an employer-sponsored retirement plan, the maximum IRA deduction was phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction was phased out between $40,000 and $50,000 of AGI. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

The Small Business Job Protection Act of 1996 modified the rule relating to the maximum deductible IRA contribution by permitting deductible IRA contributions of up to

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[3] Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

$2,000 to be made for each spouse (including a spouse who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

The Health Insurance Portability and Accountability Act of 1996 extended to IRAs the exception to the early withdrawal tax for medical expenses in excess of 7.5 percent of AGI and added the exception for health insurance expenses for unemployed individuals.

The Taxpayer Relief Act of 1997: (1) increased the AGI phase-out limits for deductible IRAs; (2) modified the AGI phase-out limits for an individual who is not an active participant in an employer-sponsored retirement plan but whose spouse is; (3) provided exceptions from the early withdrawal tax for withdrawals for education expenses and first-time home purchase (up to $10,000), and (4) created the Roth IRA.

C. Employer-Sponsored Qualified Retirement Plans and Similar Arrangements

1. Employer-sponsored qualified retirement plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code ("a qualified plan") is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified plan. Pre-tax employee contributions (e.g., contributions to a qualified cash or deferred arrangement (section "401(k) plan")) are generally treated the same as employer contributions for tax purposes.

The tax treatment of contributions under qualified plans is essentially the same as that of deductible IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and reduces pressure on the social security system.

Present law imposes a number of requirements on qualified plans that must be satisfied in order for the plan to obtain tax-favored status. For example, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees.[4] Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees[5]; (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefitting under the plan; or (3) the plan satisfies an average benefits test which compares the benefits received by highly compensated employees and nonhighly compensated employees. Present law also contains a general nondiscrimination requirement which provides that plans may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights and features, not just to contributions and benefits. Special rules apply to plans that primarily benefit key employees (called "top-heavy plans").

The plan qualification standards also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified plans.[6] Certain of the rules relating to qualified plans are designed to ensure that the amounts contributed to qualified plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from such plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified plans is restricted.

Types of qualified plans

Qualified plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided.

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[4] Pursuant to the Taxpayer Relief Act of 1997, qualified plans maintained by State and local governments are not subject to the nondiscrimination rules applicable to other qualified plans.

[5] Under present law, an employee is treated as highly compensated if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $80,000 (for 1999) or (b) at the election of the employer had compensation for the preceding year in excess of $80,000 (for 1999) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee.

[6] Qualified plans are subject to regulation under Federal labor laws (Title I of ERISA) as well as under the Internal Revenue Code. The ERISA rules generally relate to the rights of plan participants, reporting and disclosure, and the obligations of plan fiduciaries.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide an annual retirement benefit of 2 percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC"), a Federal corporation within the Department of Labor.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (called 401(k) plans after the section of the Code regulating such plans) are examples of defined contribution plans.

Limits on contributions and benefits

Under present law, limits apply to contributions and benefits under qualified plans. In the case of a defined benefit pension plan, present law limits the annual benefits payable under the plan to the lesser of (1) 100 percent of the participant's average compensation for his or her high 3 years, or (2) $130,000 (for 1999).[7] In general, the $130,000 dollar limit is increased for retirement after the social security retirement age, and decreased for retirement before the social security retirement age. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (for 1999). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The dollar limits are increased for cost-of-living adjustments in $5,000 increments. In some cases special, increased limits apply in the case of State and local government plans.

An overall limit applies if an individual is a participant in both a defined contribution plan and a defined benefit plan of the same employer. The Small Business Job Protection Act of 1996 repealed this overall limit for years beginning after December 31, 1999.

Taxation of distributions

Under present law, a distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's investment in the contract (i.e., basis). Special rules apply to lump-sum

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[7] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

distributions, distributions rolled over to an IRA or another qualified plan, and distributions of employer securities.

Early distributions from qualified plans generally are subject to the same additional 10-percent early withdrawal tax that applies to early distributions from IRAs. The early withdrawal tax does not apply to distributions from a qualified plan made to an employee after separation from service after attainment of age 55. The exceptions to the early withdrawal tax for medical insurance expenses of unemployed individuals, education expenses, and first-time homebuyer expenses do not apply to qualified plan distributions.

Qualified cash or deferred arrangements

As mentioned above, a qualified cash or deferred arrangement is a type of qualified plan. Thus, such arrangements are subject to the rules generally applicable to qualified plans. In addition, special rules apply to such arrangements.[8]

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (section 401(k) plan). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $10,000 for 1999. This dollar limit is indexed for inflation in $500 increments. An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements. Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are also subject to a special nondiscrimination test.

Under a safe harbor, a cash or deferred arrangement is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)). A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly

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[8] State and local governments may not maintain section 401(k) plans, but can maintain similar arrangements. As described below, educational institutions may maintain tax-sheltered annuities, which operate in a manner similar to section 401(k) plans, i.e., they allow employees to make elective contributions. Similarly, many State and local governments maintain section 457 plans (described below) which in practice operate like section 401(k) plans. These plans are not subject to the nondiscrimination rules applicable to section 401(k) plans.

compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to 3 percent of compensation and (b) 50 percent of the employee's elective deferrals from 3 to 5 percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Certain alternative matching arrangements also can be used to satisfy the safe harbor.

2. SIMPLE retirement plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a section 401(k) plan. If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. If established as part of a 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE retirement plan allows employees to make elective contributions which cannot exceed $6,000 (for 1999). The $6,000 dollar limit is indexed for inflation in $500 increments. The employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule applicable to SIMPLE IRAs, the employer can elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan. All contributions to an employee's SIMPLE account must be fully vested.

Contributions to a SIMPLE plan generally are deductible by the employer and excludable from the employee's income. Early withdrawals from a SIMPLE plan generally are subject to the 10-percent early withdrawal tax. However, in the case of a SIMPLE IRA, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to a 25-percent early withdrawal tax.

3. Simplified employee pensions ("SEPs")

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to defined contribution plans. The employee is always 100-percent vested in employer contributions. All employees who satisfy certain participation requirements must be eligible to participate in the SEP. An employee satisfies the participation requirements if the employee (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $400 (for 1999) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits.

Effective for taxable years beginning before January 1, 1997, certain small employers could maintain a salary reduction SEP ("SARSEP") under which employees could elect to have contributions made to the plan or to receive the contributions in cash. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, employers may continue to make contributions to SARSEPs that were established before 1997 (in accordance with the rules in effect before 1997). In addition, employees hired after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.

4. Tax-sheltered annuities ("section 403(b) annuities")

Tax-sheltered annuities ("section 403(b) annuities") are another form of employer-based retirement plan that provide the same tax benefits as qualified plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

The annual contribution to a tax-sheltered annuity generally cannot exceed the lesser of the exclusion allowance or the limit applicable to defined contribution qualified plans. The exclusion allowance for a year is equal to 20 percent of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer. In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect to have one of several special rules apply that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Employer contributions to a section 403(b) annuity are generally subject to the same nondiscrimination rules as contributions to qualified plans. Contributions made by the employee under a salary reduction agreement (i.e., contributions that are comparable to employee elective deferrals under a section 401(k) plan) are not subject to nondiscrimination rules similar to those applicable to section 401(k) plans. Instead, all employees generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.[9]

5. Eligible deferred compensation plans of State and local governments and tax-exempt entities ("section 457 plans")

Compensation deferred under an eligible deferred compensation plan (a "section 457 plan") of a tax-exempt or State or local governmental employer is includible in income when paid or made available. The maximum annual deferral under such a plan generally is the lesser of (1) $8,000 (for 1999) or (2) 33-1/3 percent of compensation (net of the deferral).

In general, amounts deferred under a section 457 plan may not be made available to a plan participant before the earlier of (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant is separated from service with the employer, or (3) when the participant is faced with an unforeseeable emergency. Amounts that are made available upon separation from service are includible in gross income in the taxable year in which they are made available.

Amounts deferred under a governmental section 457 plan must be held in trust. Amounts deferred under a section 457 plan of a tax-exempt entity must remain the property of the employer, subject only to the claims of the employer's general creditors.

With certain exceptions, section 457 generally applies to all deferred compensation of employees of tax-exempt and State and local governmental employers other than compensation deferred under a qualified plan (or a tax-sheltered annuity). Section 457 does not apply to any bona fide vacation, sick leave, compensatory time, severance pay, disability pay, or death benefit plan. In addition, section 457 does not apply to qualified governmental excess benefit plans that provide benefits in excess of those that are provided under a qualified plan maintained by the governmental employer.

Section 457 plans are not qualified retirement plans; rather, such plans have traditionally been more like unfunded, nonqualified deferred compensation arrangements of private, taxable employers. Present law does not limit the amount of deferred compensation payable under nonqualified deferred compensation plans of taxable employers because there is tension between the employer and the employee–employers generally want a current deduction for compensation, whereas deferred compensation is not deductible until includible in employees' income. This

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[9] As with qualified plans, State and local governmental tax-sheltered annuities are not subject to nondiscrimination rules.

tension is not present in the case of deferred compensation plans of tax-exempt and governmental employers. Thus, section 457 limits the amount that can be deferred under such plans and provides other rules regarding such plans.

Section 457 plans do not benefit from all the favorable tax rules applicable to qualified plans because section 457 plans generally have not been subject to all of the same restrictions and rules as qualified plans (e.g., the maximum permitted annual deferral is lower). However, recent changes in the rules relating to section 457 plans of governmental employers have blurred the distinction between governmental section 457 plans and governmental qualified plans. In particular, assets of governmental section 457 plans must now be held in trust, and governmental qualified plans are not subject to nondiscrimination rules.

D. Other Tax Incentives for Saving

1. Annuity contracts

Present law provides that income credited to a deferred annuity contract generally is not currently includible in the gross income of the owner of the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. No income cap limit applies to individuals purchasing annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract), as well as lump sum distributions after the annuity starting date, are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each annuity payment received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59-1/2, dies or becomes disabled, made in the form of certain periodic payments, or that satisfies certain other requirements.

2. Life insurance

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup"). Further, death benefits paid under a life insurance contract are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured. In addition, certain amounts received under a life insurance contract on the life of a terminally ill or chronically ill individual are treated as being received by reason of the death of the insured and therefore are excludable from income. This same favorable tax treatment applies to amounts received from the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a

terminally ill or chronically ill individual. The favorable tax treatment for life insurance contracts is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract.

Except as described above, distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income only to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the taxpayer's investment in the contract, and then as income. In the case of a modified endowment contract, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances. A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums.

No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

3. Medical savings accounts[10]

Under present law, eligible individuals covered under a high deductible health plan may have a medical savings account ("MSA"). In general, eligible individuals are individuals employed by a small employer and self-employed individuals. Within limits, contributions made by an individual to an MSA are deductible, and contributions made by the individual's employer are excludable from gross income. Earnings on amounts held in an MSA are not currently includible in income. Amounts withdrawn for medical expenses are not taxable. Amounts withdrawn for nonmedical purposes are includible in income and subject to an additional 15-percent tax unless the distribution is made after death, disability, or age 65.

While MSAs are not available to all individuals, when used for nonmedical purposes, MSAs provide the same tax benefits as IRAs and qualified plans. When used for medical purposes, they provide greater tax benefits, because both contributions and withdrawals are tax free.

4. Education tax incentives

Present law contains a number of provisions intended to assist individuals to save for education.

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[10] For a more detailed discussion of medical savings accounts see section I.D. of Part Two, below.

Exclusion for interest earned on savings bonds

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year (sec. 135). "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1999, the exclusion is phased out for taxpayers with modified AGI between $53,100 and $68,100 ($76,650 and $109,650 for joint returns). To prevent taxpayers from effectively avoiding the income phase-out limitation through issuance of bonds directly in the child's name, present law provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are least 24 years old.

Qualified State tuition programs

Present law provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (sec. 529). "Qualified higher education expenses" are defined as tuition, fees, books, supplies, equipment and certain room and board expenses required for the enrollment or attendance at a college or university (or certain vocational schools). Present law also provides that no amount is included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.

Education IRAs

Present law provides tax-exempt status to "education IRAs," meaning certain trusts (or custodial accounts) which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per designated beneficiary (except in cases involving certain tax-free rollovers, as described below), and may not be made after the

designated beneficiary reaches age 18.[11] The $500 annual contribution limit is phased out ratably for single contributors with modified AGI between $95,000 and $110,000 ($150,000 and $160,000 for joint returns).

Amounts distributed from education IRAs are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of an eligible student incurred during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). If a HOPE credit or Lifetime Learning credit is claimed with respect to a student for a taxable year, then a distribution from an education IRA may (at the option of the taxpayer) be made on behalf of that student during that taxable year, but an exclusion is not available for the earnings portion of such distribution.

Distributions from an education IRA that exceed qualified higher education expenses are includible in the distributee's gross income, and subject to an additional 10-percent tax (unless the distribution is made on account of the death, disability, or scholarship receipt of the designated beneficiary).

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[11] In addition, an excise tax applies if a contribution is made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

II. BACKGROUND INFORMATION RELATING TO TAX INCENTIVES FOR SAVING

A. Role of Saving in the National Economy

Investment and economic growth

When an economy's rate of investment increases, the economy's stock of capital increases. A larger capital stock permits greater production of goods and services. Because a larger capital stock leads to more productive workers, investment also leads to higher real wages and salaries. Thus, increases in investment lead to future increases in a nation's standard of living.

It is important to distinguish gross investment from net investment. Gross investment includes investment in new capital as well as investment that is undertaken to replace depreciated or worn out capital. Net investment measures increases to the capital stock. (Net investment is equal to gross investment less depreciation).

In the short run, increases in gross investment will increase the capital stock. As the capital stock increases and worker productivity increases, the economy will experience a higher rate of growth. In the long run, any given rate of investment will just be sufficient to replace the existing, though larger, capital stock as it depreciates. Thus, in the long run, an increase in the level of investment increases a nation's standard of living, but may not increase a country's long-run rate of growth.

It is possible that a higher investment level can lead to a higher growth rate even in the long run. Even if there is no growth in net investment, investment to replace depreciated capital may still enhance economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies. The higher the gross investment rate, the more new capital is purchased each year, and thus the rate at which new technologies get adopted may be higher.

Sources of investment funds

Investment involves a trade-off between consumption today and consumption tomorrow. Investment can either be financed by national saving, or by foreign borrowing (saving by foreigners). A basic accounting identity of the national income and product accounts states that:[12]

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[12] The national income and product accounts measure the flow of goods and services (product) and income in the economy. Two common measures of the size of the economy are the gross domestic product ("GDP") and the gross national product ("GNP"). GDP measures the total value of the output of the U.S. economy. GNP measures the total annual value of goods and services produced by U.S. residents, i.e., their gross income. GDP is greater than GNP by the

Investment = Private Saving + Government Saving + Net Foreign Borrowing

Many analysts in the past ignored the foreign sector, primarily because at the time it was small relative to the U.S. economy. These analysts interpreted this basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

However, national investment need not equal national saving if foreigners can invest in the United States. The experience of the 1980s, when investment in the United States greatly exceeded national savings, demonstrates how important this source of funds can be. When

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payment of factor income to the rest of the world (such as profits to foreign owners of U.S. based businesses), but is less than GNP by the amount of factor income received from the rest of world by U.S. residents (such as wages paid to U.S. workers who work abroad). Examining the income measure, GNP, is useful in understanding the trade-off between consumption tomorrow and consumption today. GNP may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

(1) GNP = C + I + G + (X-M).

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports of goods and services or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less domestic transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity,

(3) I = S + (T-G) + (M-X)

This is the basis for the statement that national investment equals private saving (S), plus public saving (T-G), and net imports (M-X).

demand for investment funds in the United States outstrips the supply of national savings, interest rates rise in response. Increases in interest rates attract foreign capital to the United States, and the excess of investment over national saving is financed by foreigners' saving.

Foreign investment in the United States also is related to the value of the dollar and the trade deficit. To take advantage of higher interest rates in the United States, foreign investors first must convert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and the trade deficit increases. A further accounting identity states that:[13]

Net Foreign Borrowing = (Imports-Exports)

When net foreign borrowing increases, the trade deficit (the difference between imports and exports of goods and services) also increases. Thus, many people have blamed the U.S. trade deficits of the 1980s on the low national savings rate during that period.[14]

Is the United States' saving rate too low?

Consequences of a low saving rate

The consequences of a low saving rate depend on the mobility of international capital. If capital is not mobile, then, as discussed above, investment is equal to national savings. When the saving rate is low, so is the investment rate. Historically, there has been a strong relationship between a country's rate of investment and its rate of saving.[15] Although this relationship has become weaker over time,[16] it is still true that countries with high saving rates also generally have high investment rates.

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[13] This ignores the relatively small amount of unilateral transfers to foreigners. For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

[14] For instance, see Hatsopoulos, Krugman, and Summers, "U.S. Competitiveness: Beyond the Trade Deficit," *Science*, 15 July 1988, vol. 241, pp. 299-307.

[15] See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980), pp. 314-329.

[16] See Phillippe Bacchetta and Martin Feldstein, "National Saving and International Investment," in Douglas Bernheim ad John Shoven (eds.), *National Saving and Economic Performance*, (Chicago: The University of Chicago Press), 1991.

If capital is mobile (that is, if foreigners can invest in the United States at low cost and without a lot of added risk), then investment will not decline as much when the saving rate falls. Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign lending to U.S. investors. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than would be possible if investment were financed by domestic saving. Foreign investment in the United States does increase the productivity of U.S. workers. However, the profits generated by foreign investment flow abroad, since the United States has to pay interest on the funds it borrows. Furthermore, eventually the debt will have to be repaid, so the net wealth that is left to future generations of U.S. residents is smaller than it would be if the investment were financed by domestic saving.

Trends in national saving and investment

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). In the tables that follow, personal saving is measured as the difference between household income and household consumption. In addition, the National Income and Product Accounts attribute all corporate pension contributions and earnings on accumulated pension balances as saving by the household sector and, hence, part of personal saving. Personal saving does not include changes in values of household assets, such as have occurred over the past few years as stock market values have increased. Businesses save by retaining some of their earnings. Tables 1 and 2 present net saving, which equals gross saving less capital consumption (depreciation). Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses or deficits. The National Income and Product Accounts also adjust government surpluses for depreciation of government assets. Hence, public saving, like business saving, is measured as net saving. Table 1 presents data on the components of net national saving in the United States.

Table 2 presents net saving by component as a percentage of gross domestic product ("GDP"). As the table demonstrates, net business saving, net private saving, and public saving were all lower during the 1980s then in any of the three previous decades. Net national saving declined through most of the 1980s, and has fallen to lower levels in the 1990s. Figure 1 plots the data of Table 2 for net national saving, net private saving, and net public saving. Over the past five years, reductions in the Federal Government's deficit (and actual surplus in 1998) combined with increasing surpluses by State and local governments have more than offset measured declines in private saving.

Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GDP. Table 3 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 2 are evident in Table 3.

Table 1.--Components of Net National Saving, 1959-1998

		Net Private Saving			Net Public Saving			
Year	Gross Domestic Product ($ billions)	Personal Saving ($ billions)	Net Business Saving ($ billions)	Total Net Private Saving ($ billions)	Federal Government Saving ($ billions)	State & Local Net Saving ($ billions)	Total Net Public Saving ($ billions)	Net National Saving ($ billions)
1959	507.2	25.2	16.5	41.7	2.6	9.6	12.2	53.9
1960	526.6	24.2	15.3	39.5	7.4	9.9	17.3	56.8
1961	544.8	29.2	15.7	44.9	2.9	10.4	13.3	58.2
1962	585.2	30.4	21.5	51.9	2.8	11.7	14.5	66.4
1963	617.4	29.5	24.0	53.5	5.4	13.0	18.4	71.9
1964	663.0	36.4	27.3	63.7	0.9	14.7	15.6	79.3
1965	719.1	38.7	33.1	71.8	3.4	15.1	18.5	90.3
1966	787.8	40.1	35.2	75.3	2.6	17.3	19.9	95.2
1967	833.6	49.9	32.7	82.6	-8.3	17.3	9.0	91.6
1968	910.6	47.8	30.2	78.0	-2.8	20.0	17.2	95.2
1969	982.2	47.9	26.0	73.9	8.7	21.1	29.8	103.7
1970	1,035.6	62.0	20.7	82.7	-14.1	20.8	6.7	89.4
1971	1,125.4	69.9	30.5	100.4	-25.3	21.7	-3.6	96.8
1972	1,237.3	65.2	39.0	104.2	-20.5	32.2	11.7	115.9
1973	1,382.6	91.5	42.7	134.2	-11.1	33.4	22.3	156.5
1974	1,496.9	100.2	27.0	127.2	-16.9	30.5	13.6	140.8
1975	1,630.6	107.8	47.2	155.0	-73.9	27.6	-46.3	108.7
1976	1,819.0	100.4	54.8	155.2	-57.2	35.9	-21.3	133.9
1977	2,026.9	97.2	70.5	167.7	-46.3	44.7	-1.6	166.1
1978	2,291.4	118.2	79.5	197.7	-31.7	52.6	20.9	218.6
1979	2,557.5	136.2	72.6	208.8	-18.4	52.3	33.9	242.7
1980	2,784.2	169.1	44.1	213.2	-61.0	54.4	-6.6	206.6
1981	3,115.9	207.2	56.4	263.6	-57.8	55.4	-2.4	261.2
1982	3,242.1	210.9	52.5	263.4	-134.7	51.3	-83.4	180.0
1983	3,514.5	169.7	83.6	253.3	-174.4	64.9	-109.5	143.8
1984	3,902.4	241.5	116.8	358.3	-156.0	86.9	-69.1	289.2

Year	Gross Domestic Product ($ billions)	Net Private Saving: Personal Saving ($ billions)	Net Private Saving: Net Business Saving ($ billions)	Net Private Saving: Total Net Private Saving ($ billions)	Net Public Saving: Federal Government Saving ($ billions)	Net Public Saving: State & Local Net Saving ($ billions)	Net Public Saving: Total Net Public Saving ($ billions)	Net National Saving ($ billions)
1985	4,180.7	207.4	123.6	331.0	-162.9	91.0	-71.9	259.1
1986	4,422.2	188.6	95.9	284.5	-177.5	94.9	-82.6	201.9
1987	4,692.3	168.9	110.0	278.9	-128.9	83.8	-45.1	233.8
1988	5,049.6	195.2	134.0	329.2	-121.3	85.9	-35.4	293.8
1989	5,438.7	194.8	104.3	299.1	-113.4	95.1	-18.3	280.8
1990	5,743.8	213.3	112.7	326.0	-154.7	80.1	-74.6	251.4
1091	5,916.7	243.5	130.8	374.3	-196.0	75.8	-120.2	254.1
1992	6,244.4	264.1	137.1	401.2	-280.9	86.3	-194.6	206.6
1993	6,558.1	210.3	170.1	380.4	-250.7	87.4	-163.3	217.1
1994	6,947.0	176.8	201.4	378.2	-186.7	96.8	-89.9	288.3
1995	7,269.6	179.8	256.1	435.9	-174.4	111.7	-62.7	373.2
1996	7,661.6	158.5	262.4	420.9	-110.3	122.6	12.3	433.2
1997	8,110.9	121.0	296.7	417.7	-21.1	134.1	113.0	530.7
1998	8,511.0	27.7	305.4	333.1	72.8	150.2	223.0	556.1

Source: Department of Commerce, Bureau of Economic Analysis.

Table 2.--Components of Net National Saving in the United States as a Percentage of GDP, 1959-1998

	Net Private Saving				
Year	Personal Savings	Net Business Savings	Net Private Savings	Public Savings	Net National Savings
1959	4.97	3.25	8.22	2.41	10.63
1960	4.60	2.91	7.50	3.29	10.79
1961	5.36	2.88	8.24	2.44	10.68
1962	5.19	3.67	8.87	2.48	11.35
1963	4.78	3.89	8.67	2.98	11.65
1964	5.49	4.12	9.61	2.35	11.96
1965	5.38	4.60	9.98	2.57	12.56
1966	5.09	4.47	9.56	2.53	12.08
1967	5.99	3.92	9.91	1.08	10.99
1968	5.25	3.32	8.57	1.89	10.45
1969	4.88	2.65	7.52	3.03	10.56
1970	5.99	2.00	7.99	0.65	8.63
1971	6.21	2.71	8.92	-0.32	8.60
1972	5.27	3.15	8.42	0.95	9.37
1973	6.62	3.09	9.71	1.61	11.32
1974	6.69	1.80	8.50	0.91	9.41
1975	6.61	2.89	9.51	-2.84	6.67
1976	5.52	3.01	8.53	-1.17	7.36
1977	4.80	3.48	8.27	-0.08	8.19
1978	5.16	3.47	8.63	0.91	9.54
1979	5.33	2.84	8.16	1.33	9.49
1980	6.07	1.58	7.66	-0.24	7.42
1981	6.65	1.81	8.46	-0.08	8.38
1982	6.51	1.62	8.12	-2.57	5.55
1983	4.83	2.38	7.21	-3.12	4.09
1984	6.19	2.99	9.18	-1.77	7.41

Year	Net Private Saving: Personal Savings	Net Private Saving: Net Business Savings	Net Private Saving: Net Private Savings	Public Savings	Net National Savings
1985	4.96	2.96	7.92	-1.72	6.20
1986	4.26	2.17	6.43	-1.87	4.57
1987	3.60	2.34	5.94	-0.96	4.98
1988	3.87	2.65	6.52	-0.70	5.82
1989	3.58	1.92	5.50	-0.34	5.16
1990	3.71	1.96	5.68	-1.30	4.38
1991	4.12	2.21	6.33	-2.03	4.29
1992	4.23	2.20	6.42	-3.12	3.31
1993	3.21	2.59	5.80	-2.49	3.31
1994	2.54	2.90	5.44	-1.29	4.15
1995	2.47	3.52	6.00	-0.86	5.13
1996	2.07	3.42	5.49	0.16	5.65
1997	1.49	3.66	5.15	1.39	6.54
1998	0.33	3.59	3.91	2.62	6.53
Average 1960-69	5.22	3.64	8.86	2.42	11.28
Average 1970-79	5.71	2.92	8.63	0.22	8.85
Average 1980-89	4.84	2.28	7.13	-1.30	5.83
Average 1990-98	2.53	2.97	5.51	-0.57	4.94

Source: Department of Commerce, Bureau of Economic Analysis.

Figure 1.--Components of Net National Saving as a Percentage of GDP, 1959-1998

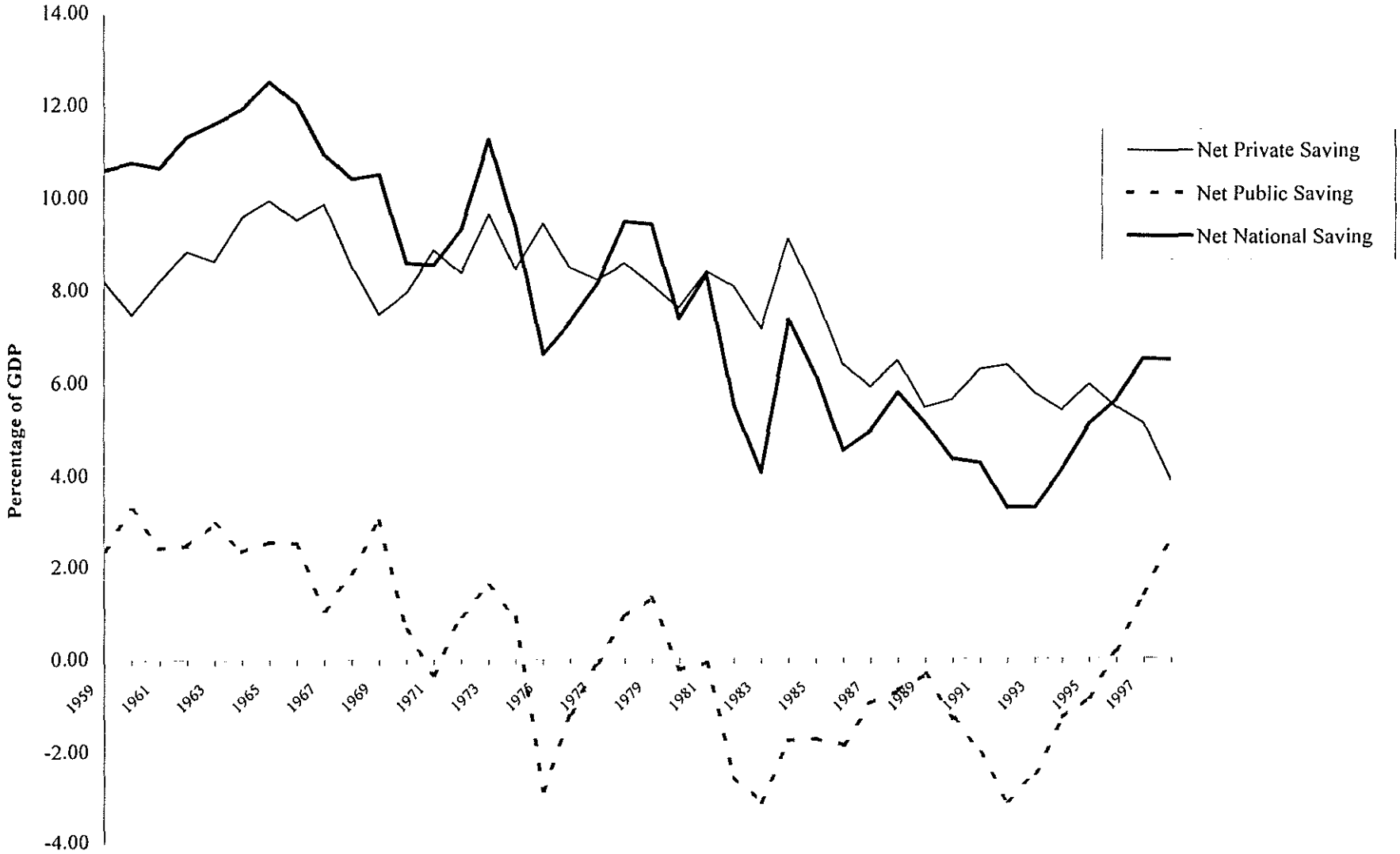

Table 3.–U.S. Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929-1998

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	7.2
1964	7.9
1969	7.2
1974	9.5
1975	9.3
1976	7.9
1977	6.9
1978	7.5
1979	7.7
1980	8.5
1981	9.4
1982	9.0
1983	6.7
1984	8.6
1985	6.9
1986	5.9
1987	5.0
1988	5.4
1989	5.0
1990	5.1
1991	5.6
1992	5.7
1993	4.4
1994	3.5
1995	3.4
1996	2.9
1997	2.1
1998	0.5

Source: Department of Commerce, Bureau of Economic Analysis.

Prior to 1980, domestic saving generally financed domestic investment as well as providing funds for the United States to be a net investor abroad (negative net foreign investment). During the 1980s, net savings fell short of domestic investment as a share of GDP. Domestic investment declined from its 1984 peak and net foreign investment provided for the difference in domestic savings and investment. Thus, although the decline in U.S. saving was coincident with a decline in investment, this decline was not as severe as it might have been had there not been foreign investment.

Comparison between the saving rates of the U.S. and other countries

The United States' national saving rate is low when compared to that of other nations. Table 2 shows that the United State's net national saving averaged approximately 6 percent of GDP in the 1980s and approximately 5 percent thus far in the 1990s. The net national saving rate of Canada during the 1980s averaged 7.3 percent of GDP. For Japan, the comparable rate was 17.9 percent; Germany, 9.2 percent; Italy, 8.3 percent; France, 6.7 percent; the United Kingdom, 4.5 percent; and Australia, 3.4 percent.[17] Table 4 presents a comparison for household or personal saving. As Table 4 indicates, the household saving rate of the United States during the past decade was below the household saving rates of Canada, Germany, Japan, and the United Kingdom.[18]

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[17] Organization for Economic Co-Operation and Development, *National Accounts, 1960-1989*, vol. 1, 1991.

[18] The data on international saving rates in the text and in Table 4 are not directly comparable to the data in Tables 2 and 3 because such data are not always compiled consistently across nations. For example, in computing household saving rates, the OECD subtracts household interest expense from income to determine U.S. household disposable income. The Bureau of Economic Analysis does not make a similar adjustment in defining household disposable income. Also, while the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical across all countries. In particular, except in Japan, France, and Italy, private nonprofit institutions are included in the household sector. See, Andrew Dean, Martine Durand, John Fallon, and Peter Hoeller, "Saving Trends and Behaviour in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

Table 4.–Net Household Saving as a Percentage of Disposable Household Income in Certain Countries, Selected Years, 1972-1997

Country	1972	1976	1980	1984	1988	1990	1992	1994	1995	1996	1997	Average 1988-1997
United States	7.5	7.6	8.4	8.6	5.3	5.2	5.7	4.2	4.9	4.4	4.0	5.2
Japan	18.2	23.2	17.9	15.8	13.0	12.1	13.1	12.8	13.0	13.8	13.6	13.2
Germany	14.4	13.3	12.8	11.4	12.8	13.8	12.9	11.7	11.6	11.7	11.8	12.4
United Kingdom	6.4	10.9	13.4	11.1	6.2	8.2	12.0	10.4	11.7	11.4	11.1	10.0
Canada	8.7	11.8	13.6	15.0	9.7	9.7	10.3	7.6	7.0	5.9	1.9	9.1
Australia	11.8	11.1	10.8	9.9	6.1	6.9	4.6	3.2	2.6	4.6	3.9	4.1

Source: Organization for Economic Co-Operation and Development, *OECD Economic Outlook*, 63, June 1998 and earlier issues.

Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between 1967 and 1995 is greater than the decline of the saving rates of Japan and Germany, but comparable to the decline of some other western, industrialized countries.

Although many people have pointed to the low saving rate in the United States as a cause of declining productivity, others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory.

Furthermore, some argue that the low saving rate in the United States may be a product of demographics, and that the saving rate will increase as the baby boomers continue to enter their forties and fifties, typically the years during which people do much of their retirement saving. However, others note that in the past, demographic changes have not been very successful at predicting saving rates.

In general, the decline in private saving rates is not well understood. It is likely that demographic changes, capital market liberalization, increased insurance availability, and increased social security benefits have all contributed to the decline. However, these factors have not proved significant enough to account for the total decline in the saving rate. Similarly, there is no convincing explanation for why saving rates have declined in other nations as well.

B. Tax Incentives for Saving

Goals of tax incentives for saving

Some argue that tax incentives for saving are appropriate because the income tax system taxes the return to income that is saved, thereby lowering the return to saving. This lower return on saving affects both the national saving rate, as well as the assets that taxpayers accumulate for particular purposes. There is some disagreement about whether the goal of tax incentives for saving should be to encourage saving for particular purposes or to increase national saving. These purposes are not mutually exclusive; if effective, incentives to save for particular purposes will increase national saving. However, general saving incentives will not necessarily fulfill more specific goals. Whether new tax incentives for saving should be aimed at increasing national saving in general, or increasing retirement saving, depends on the perceived adequacy of each type of saving.

Efficacy of tax incentives for saving

Overview

Tax incentives for saving may have a number of attributes that may affect a taxpayer's saving decision. First, investments in tax-advantaged assets or accounts earn a higher after-tax

rate of return than investments in other assets which may lead to an increase or decrease in saving. Second, a targeted savings incentive may provide an incentive for a specific form of saving relative to other forms of saving. Third, a tax incentive for saving may provide a psychological incentive to save. Fourth, advertising by banks and other financial institutions of tax-benefitted savings vehicles may influence people's saving decisions. The following discussion focuses on each of these attributes.

Rate of return

Tax exclusions or deferrals for the income earned from saving increase the rate of return to saving. When the return on saving increases, the price of future consumption decreases, because the taxpayer has to forgo fewer dollars today to consume a dollar's worth of consumption in the future.

This price decrease can affect saving in two ways. Since future consumption is now cheaper, taxpayers may choose to substitute future consumption for current consumption. This effect increases saving. When the price of future consumption falls, though, the amount of investment necessary to achieve any particular level of income in the future decreases. For example, a taxpayer in the 28-percent marginal tax bracket may set aside $1,300 today to help defray tuition expenses of his child 15 years from now. If the taxpayer's investment earns 8 percent annually and those earnings are taxed annually at a 28-percent tax rate, in 15 years the investment will be worth $3,000. If the taxpayer instead invested in a Roth IRA, an investment of only $946 today would be worth $3,000 in 15 years (assuming the same 8-percent return). This effect decreases saving because the tax benefit permits the taxpayer to save less to accumulate the same amount of money in the future.

Substantial disagreement exists among economists as to the effect on saving of increases in the net return to saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.[19] Other studies have argued that large behavioral responses to changes in the after-tax rate of return will not necessarily occur.[20] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive

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[19] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, September 1981.

[20] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington: Brookings Institution), 1988.

results. Some find personal saving responds strongly to increases in the net return,[21] while others find little or a negative response.[22]

Even if increasing the rate of return on all saving does increase saving generally, it is still possible that increasing the rate of return on qualified plans or IRAs would not affect saving. For increased rates of return to influence taxpayers to substitute future consumption for current consumption, the marginal rate of return on savings must increase so that if the taxpayer increases saving, that saving receives a higher rate of return. In order for a savings incentive to increase the marginal return to saving, taxpayers must not be able to finance the tax-preferred saving profitably by borrowing, must not have other similar assets that can be easily shifted into tax-preferred assets or accounts, and must (in the absence of the saving incentive) intend to save less than the maximum contribution allowed.

Type of saving

The above discussion focused on saving in general. Many authors have noted that qualified plans and IRAs may provide incentives for retirement saving, as opposed to saving for other purposes.[23] For instance, consider the effect of a qualified plan, distributions from which are subject to additional tax unless held until retirement or used for other qualified purposes. An individual who is saving only for a "rainy day" may not have much saving that is expected to last until retirement. When offered a higher rate of return on retirement saving, that individual may choose to increase the total amount of saving by maintaining the rainy day saving and adding retirement saving.

Psychological factors and effects of increased advertising

Several observers have observed that factors other than rates of return, or what might be termed "non-economic" factors, are important in motivating saving through qualified plans and other saving incentives. Researchers have found that both participation in and contributions to voluntary savings plans, such as qualified pension plans, are significantly higher when employers offer retirement seminars. These analysts found that the effect was stronger for nonhighly compensated employees than for highly compensated employees. Moreover, the frequency of

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[21] See, Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, April 1978.

[22] See, George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior* (Washington: Brookings Institution), 1981.

[23] See the discussion in William G. Gale and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, 84, December 1994, and Steven F. Venti and David A. Wise, "Tax Deferred Accounts, Constrained Choice, and Estimation of Individual Saving," *Review of Economic Studies*, 53, August 1996.

such seminars was an important correlate to saving behavior, but the provision of written materials in the absence of seminars appeared to have no effect.[24] Other research suggests that high school level education in financial decision-making appears to raise asset accumulation by the students once they reach adulthood.[25]

Some observers have noted that IRAs may have a larger impact on saving than standard economic analyses would predict.[26] These observers suggest that the immediate reward of the tax deduction and the active marketing campaigns in the mid-1980s contributed to the high IRA participation rates observed; in fact, IRA participation was larger than was expected. The sharp decline in advertising after 1986 may explain the decline in IRA contributions among taxpayers who are still eligible.

Furthermore, there may also be a psychological factor that contributes to the impact of IRAs on saving. One study found that taxpayers who owed money to the IRS in excess of taxes withheld were significantly more likely to make IRA contributions than were other taxpayers.[27] One might expect this psychological factor only to induce deductible IRA contributions, which will have an immediate effect on taxes paid. However, another author[28] noted that taxpayers who owe the IRS money generally have higher incomes and this may be why they are more likely to contribute to IRAs, rather than any psychological factor.

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[24] Patrick J. Bayer, B. Douglas Bernheim, and John Karl Scholz, "The Effects of Financial Education in the Workplace: Evidence from a Survey of Employers," National Bureau of Economic Research, Working Paper #5655, July 1996.

[25] B. Douglas Bernheim, Daniel M. Garrett, and Dean M. Maki, "Education and Saving: The Long-Term Effects of High School Financial Curriculum Mandates," National Bureau of Economic Research, Working Paper #6085, July 1997.

[26] See, Richard H. Thaler, "Psychology and Savings Policies," *American Economic Review*, 84, May 1984.

[27] Daniel Feenberg, and Jonathan Skinner, "Sources of IRA Saving," in Lawrence Summers (ed), *Tax Policy and the Economy*, vol. 3, (Cambridge: Massachusetts Institute of Technology Press), 1989.

[28] Jane Gravelle, "Do Individual Retirement Accounts Increase Savings?" *Journal of Economic Perspectives*, 5, Spring 1991.

C. The Adequacy of Retirement Savings

1. Economic status of the elderly

Sources of retirement income

Social Security is the largest source of retirement income (39 percent in 1996), followed by earnings (22 percent in 1996), employee pensions, annuities, and alimony (18 percent in 1996), and income from assets (17 percent in 1996).[29] (See Figure 2.) Many researchers have attempted to measure whether people have adequate savings for retirement. A common measure of retirement savings adequacy is called the replacement rate, which is defined as the ratio of retirement income to income during the working years.

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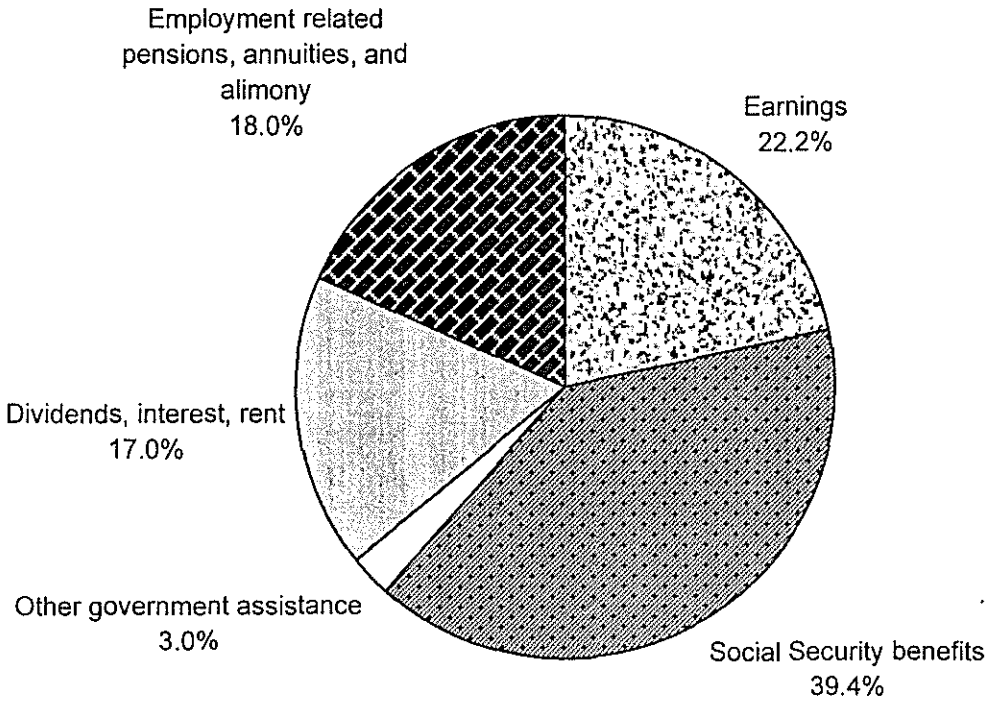
[29] Calculations by the Joint Committee on Taxation staff based on Social Security Administration, *Annual Statistical Supplement to the Social Security Bulletin, 1998*, November 1998, Table 3.E.3.

Figure 2.--Shares of Money Income From Earnings and Other Sources of the Aged, 1996



Source: Social Security Administration.

The issue of what replacement rate should be called adequate depends on a number of factors. A replacement rate of 100 percent means that the person's income during retirement is equal to their income during working years. There are a number of reasons that a replacement rate of 100 percent may not be optimal. First, people may desire to have more income during the working years because some of that income is saved for retirement. If people choose to have constant consumption over time, they save during their working years and dissave during retirement. Thus, if a household has a 10-percent saving rate during their working years, a 90-percent replacement rate would be sufficient for the household to maintain constant consumption in retirement. Second, most elderly own their own homes (in 1996, more than 81 percent of those households headed by an individual aged 65 to 74 and 75.3 percent of households headed by an individual age 75 or over[30]) and most of these have paid off their mortgages. Only 25 percent of households headed by a person aged 65 to 74 years old had any mortgage or home equity debt. Among households headed by a person aged 75 years or older, only seven percent had any mortgage or home equity debt.[31] Thus, most elderly receive housing without incurring any expenses beyond maintenance, property taxes, insurance, and utilities, whereas during their working years, they were likely to have been making mortgage payments. Third, few elderly households care for children, and therefore household expenses are likely to be lower. Fourth, the elderly are generally covered by Medicare, which provides insurance against large medical expenses and pays for most expenditures on health. Fifth, retirement income generally bears a lower tax burden than does wage income. Salaries and wages are subject to the payroll tax. Retirement benefits are not. Also, Social Security benefits, which represent the major source of retirement income, are largely untaxed.[32] Thus, Social Security benefits can be smaller than income earned during the working years and still provide the same after-tax income. For the lowest income groups, this effect is not large since earned income is subject to the payroll tax, but may not be subject to the income tax.

These arguments suggest that the appropriate replacement rate for the elderly to have adequate retirement savings is less than 100 percent. However, there may be some factors which dictate that the replacement rate should be higher than 100 percent. First, although the elderly are covered by Medicare, they are also more likely to incur large medical expenses which may not be completely covered by medicare. Similarly, Medicare generally does not cover nursing home care or the costs of care in other long-term care facilities, and only those elderly poor enough to receive Medicaid or eligible through veterans' assistance are covered. Second, the elderly may find it necessary to hire service providers for tasks that younger households provide for

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[30] *Statistical Abstract of The United States 1997*, Table 1200, p. 725.

[31] *Statistical Abstract of The United States 1997*, Table 780, p. 513.

[32] Social Security benefit recipients with modified AGI exceeding certain limits have to include up to 85 percent of their benefits in income. The Joint Committee on Taxation staff projects that in 1999, 33 percent of all elderly will include some portion of Social Security benefits in taxable income.

themselves. For example, elderly households may contract for home repair work that young households self-provide.

Replacement rates for Social Security and pension income for retired workers are calculated using two methods. The first method calculates the ratio of Social Security and pension benefits relative to a worker's highest career earnings.[33] The second method calculates benefits relative to the average earnings in the five years preceding retirement.[34] It seems likely that the career high earnings overstate average earnings, and earnings during the five years preceding retirement understate average earnings. Thus, these two replacement rates may be seen as upper and lower bounds of estimates of the replacement of average career earnings. These replacement rates measure the replacement of income through retirement benefits, and do not include any income earned during retirement or any income from savings. Such calculations indicate that Social Security and pension benefits replace roughly 33 percent of the career high earnings and 50 percent of earnings over the last five years for individuals. When spousal benefits are taken into account, replacement rates are slightly higher, averaging 30 to 33 percent of highest earnings but 60 to 70 percent of last earnings. Such calculations also demonstrate that replacement rates are highest for the poor. For the lowest income quartile, individual replacement rates varied between 34 and 39 percent of highest earnings, and 72 to 94 percent of last earnings.[35]

Analysis of more recent retirees suggests similar outcomes. A recent study calculated replacement rates for families with at least one individual between the ages 52 and 61 years old in 1992. Such individuals generally would be expected to retire between 1993 and 2006.[36] This study attempted to account for all sources of non-earnings income of retiree households: social security benefits; pension benefits; private saving; equity in personal residences; and equity in business assets. The authors calculate that in 1992, prior to actual retirement, these households, on average, held assets sufficient to produce income in retirement that would replace 86 percent of their pre-retirement income. For households in the median 10 percent of the population (i.e., those with incomes between the 45th and 55th percentiles of the income distribution), the

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[33] Earnings are indexed by the rate of wage growth. Highest career earnings are defined as the average of the highest five years of earnings.

[34] This measure is calculated only for those individuals who worked a significant amount during the five years preceding retirement.

[35] Susan Grad, "Earnings Replacement Rates of New Retired Workers," *Social Security Bulletin*, 53, October 1990.

[36] Alan L. Gustman and Thomas L. Steinmeiner, "Effects of Pensions on Savings: Analysis with Data from the Health and Retirement Study." National Bureau of Economic Research, Working Paper #6681, August 1998. Replacement rates in this study are measured relative to pre-retirement earnings of the household.

replacement rate was 97 percent. The bottom 10 percent of earners had the highest replacement rates and the top 5 percent of earners had the lowest replacement rates.[37] However, other analysts reviewing the same data suggest a less optimistic outlook. They conclude that, if the median household intended to retire at age 62, it would need to save 16 percent of future annual earnings to preserve pre-retirement consumption. The authors observe that a saving rate of 16 percent exceeds the median household's observed saving rate of approximately 5 percent.[38]

Finally, Social Security benefits have increased over time. Social Security benefits relative to the income of the elderly have increased substantially over the past 40 years. On the other hand, a current concern is whether the Federal Government will be able to continue paying the promised benefits. If benefits were to be reduced for future retirees, the replacement rates reported above would overstate likely future replacement rates.

Poverty

Another method used to examine the economic status of the elderly is to compare their rates of poverty to those of the general population. Poverty among the elderly has declined dramatically over the last 30 years, from over 35 percent in 1959 to 12.6 percent in 1985. By 1985, the poverty rate of the elderly was less than the poverty rate of the general population. In 1996, the poverty rate of the elderly was 10.8 percent and the poverty rate of elderly persons living in families (with a spouse or children) was 5.6 percent, lower than for any other group.[39] The major explanation for this decline in poverty is the increase in Social Security benefits and coverage described above.

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[37] The reported replacement rates measured replacement income in terms of nominal dollars. If the calculation were to account for future inflation, the authors estimated that real (inflation adjusted) replacement rates averaged 60 percent across all of the households in the sample and 66 percent of the real value of the pre-retirement earnings for the median 10 percent of households. See, Gustman and Steinmeier, "Effects of Pensions on Savings," pp. 18-19.

[38] James F. Moore and Olivia S. Mitchell, "Projected Retirement Wealth and Savings Adequacy in the Health and Retirement Study," National Bureau of Economic Research, Working Paper # 6240, October 1997. Moore and Mitchell estimate that the necessary saving rate falls to 7 percent per year if the household would defer retirement until age 65. Moore and Mitchell measure "pre-retirement consumption" by reference to replacement rates of less than 100 percent. Thus, if a 100-percent replacement rate were the goal, an even greater saving rate would be necessary.

[39] Social Security Administration, *Annual Statistical Supplement to the Social Security Bulletin, 1998, November 1998*, Table 3.E.2.

2. Expected retirement income and needs of current workers

The above discussion demonstrates that, as a group, the elderly are as well off as the rest of society, indicating that, given Social Security and pension benefits, savings were adequate. However, to determine whether the savings of current workers are enough to provide adequate retirement income, it is necessary to examine how this group might differ from current retirees.

Social Security and employer-provided pension plan coverage

Social Security coverage.--Because Social Security coverage of workers has increased over time,[40] and because the labor force participation of women has also been increasing, current workers are more likely to be covered by Social Security than current retirees. In 1996, out of more than 150 million workers, 6.6 million workers were not in employment covered by Social Security. Most of these were Federal, State, and local government employees. The percentage of uncovered workers will further decrease in the future as all Federal employees hired after 1983 are covered and beginning in 1991 all State and local employees who are not members of a public retirement system were mandatorily covered under Social Security.

Current pension coverage.--Similarly, pension coverage of current workers is also substantially larger than that of current retirees.[41] The term "covered," as used here, means that an employee is accruing benefits in an employer pension or other retirement plan. The best current comprehensive evidence on pension coverage comes from a supplement to the April 1993 Current Population Survey conducted by the Bureau of the Census. The data referred to below come from that survey unless otherwise noted.

As of April 1993, 63 percent of full-time wage and salary workers employed in the private sector reported that they worked in firms with an employer-sponsored pension plan. Half of the full-time wage and salary workers employed in the private sector were covered by an employer-sponsored pension plan. Most of these workers were covered by basic defined benefit or defined contribution plans (23 percent), and another 10 percent had both a basic plan and a

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[40] For a discussion of the legislative history of social security coverage, see Committee on Ways and Means, *1998 Green Book* (WMCP 105-7), May 19, 1998, pp. 6-11.

[41] *EBRI Databook on Employer Benefits*, Fourth Edition 1997. Table 10.2 on page 84 reports that in 1975, 31 million employees were participants in private sector pension plans. By 1993 this number had expanded to 45 million employees. Among all civilian workers, the percentage participating in a pension plan has grown from 44 percent in 1979 to 51 percent in 1993 (Table 10.4, p. 86).

401(k) type contributory plan (see Table 5).[42] For another 17 percent, a 401(k) type plan was their only retirement plan.

Pension coverage varies substantially among full-time, privately employed workers. Differences depend on the age of the worker, job earnings, the industry of employment, and the size of the firm. Younger workers are much less likely to be covered by a pension than middle aged and older workers. Coverage rates rise steadily from 21 percent for those under age 25 to about 60 percent for those between ages 40 and 60 before falling off somewhat. This pattern holds for both men and women. However, the jump in coverage for middle aged men is slightly larger than the increase for middle aged women (see Table 6).

Higher paying jobs are more likely to offer pensions. Just 8 percent of full-time private wage and salary workers earning less than $10,000 per year in 1993 were covered compared to 81 percent of those earning $50,000 or more (see Table 7). Coverage may be higher for higher paying jobs because of the greater value of the pension tax benefits to workers in higher tax brackets and because of the declining replacement rate of Social Security at higher earnings levels.

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[42] Some private-sector employees contribute to 403(b) tax-sheltered annuities instead of 401(k) plans.

Table 5.–Employer Sponsorship and Employee Coverage Under Pension or Retirement Plan, Private Wage and Salary Workers, 1993

[Percent]

Item	Total	Full time	Part time
Employer sponsorship:			
Employer sponsors plan	58	63	37
Basic pension only	24	24	23
Basic and 401(k) type	14	16	4
401(k) type only	21	23	10
Employer does not sponsor	35	32	49
Does not know	7	5	14
Employer Coverage:			
Employee covered under plan	43	50	12
Basic pension only	20	23	7
Basic and 401(k) type	8	10	2
401(k) type only	15	17	4
Employee is not covered	50	44	73
Does not know	7	6	14
Number of private wage and salary workers (in thousands)	88,679	72,752	15,927

Source: Department of Labor, 1994, tables A2, B1, B2.

Table 6.–Coverage Under Employer-Sponsored Pension or Retirement Plans for Full-Time Private Wage and Salary Workers, 1993

Age (in years)	Percent covered		
	Total	Men	Women
Under 25	21	19	22
25-29	41	41	42
30-34	50	50	51
35-39	54	57	51
40-44	58	61	54
45-49	63	66	59
50-54	61	60	62
55-59	59	60	57
60-64	56	59	52
65 or older	46	54	34
Total	50	51	48

Source: U.S. Department of Labor, 1994, table B5.

Table 7.–Coverage Under Employer-Sponsored Pension or Retirement Plans for Full-Time Private Wage and Salary Workers by Workers' Wages, 1993

Wages	Percent covered		
	Total	Men	Women
Under $10,000	8	7	9
$10,000-$14,999	27	21	31
$15,000-$19,999	42	35	49
$20,000-$24,999	57	51	65
$25,000-$29,999	62	61	64
$30,000-$34,999	67	66	71
$35,000-$39,999	73	74	72
$40,000-$49,999	78	79	77
$50,000-$74,999	81	81	80
$75,000 or over	81	81	78
Total[1]	50	51	48

[1] Total includes workers not responding on wages, not shown separately.

Source: U.S. Department of Labor, 1994, table B11.

Significant differences in coverage also are apparent between full-time private wage and salary workers and other wage and salary workers. Coverage is much lower among part-time workers and much higher among public employees. Among part-time, private wage and salary workers, 12 percent are covered. Seventy-seven percent of public sector wage and salary workers are covered including 85 percent of those who are full-time workers (see Table 8).

Coverage is much lower for smaller firms. Smaller firms are less likely to offer comprehensive fringe benefit packages as part of total compensation. Only 13 percent of full-time private wage and salary workers in firms with fewer than 10 employees are covered.

The rate rises with employer size but does not reach 50 percent (the average across all firm sizes) until firms have 100 or more employees.

The data above report pension coverage of individuals. When assessing the effectiveness of pensions in providing retirement income, it is more relevant to think of pension coverage of households. Thus, if both the husband and wife work and only the wife accrues pension benefits, the tables above would record that 50 percent of individuals are covered by a pension. However, in this example, 100 percent of the households (the married couple) receive pension retirement benefits. A recent study highlights the importance of this distinction. It found that in 1992, half of all individuals aged 51 to 61 years old, that is on the verge of retirement, had rights to a pension from a current or prior job, but two-thirds of all households with at least one member aged 51 to 61 years old owned the rights to a pension from a current or prior job.[43]

Trends in pension coverage.-- At the outset of World War II, private employer pensions were offered by about 12,000 firms. Pensions spread rapidly during and after the war, encouraged by high marginal tax rates and wartime wage controls that exempted pension benefits. By 1972, when the first comprehensive survey was undertaken, 48 percent of full-time private employees were covered. Subsequent surveys found that coverage reached 50 percent in 1979, but by 1983 had fallen back to 48 percent. The decline continued in the 1980s, reaching 46 percent in 1988.[44] By 1993, coverage had returned to 50 percent.

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[43] Gustman and Steinmeier, "Effects of Pensions on Savings," pp. 8-9.

[44] J.R. Woods, "Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings from the 1988 Survey of Employee Benefits," *Social Security Bulletin*, 52, p.17.

Table 8.–Coverage Under Employer-Sponsored Pension or Retirement Plans for Full-Time Private Wage and Salary Workers by Workers' Wages, 1993

Sector	Percent covered		
	Total	Men	Women
All wage and salary workers	49	56	15
Men	51	56	9
Women	46	56	17
Private sector	43	50	12
Men	46	51	8
Women	39	48	15
Public sector	77	85	30
Men	80	86	22
Women	74	84	33

Source: U.S. Department of Labor, 1994, table B1.

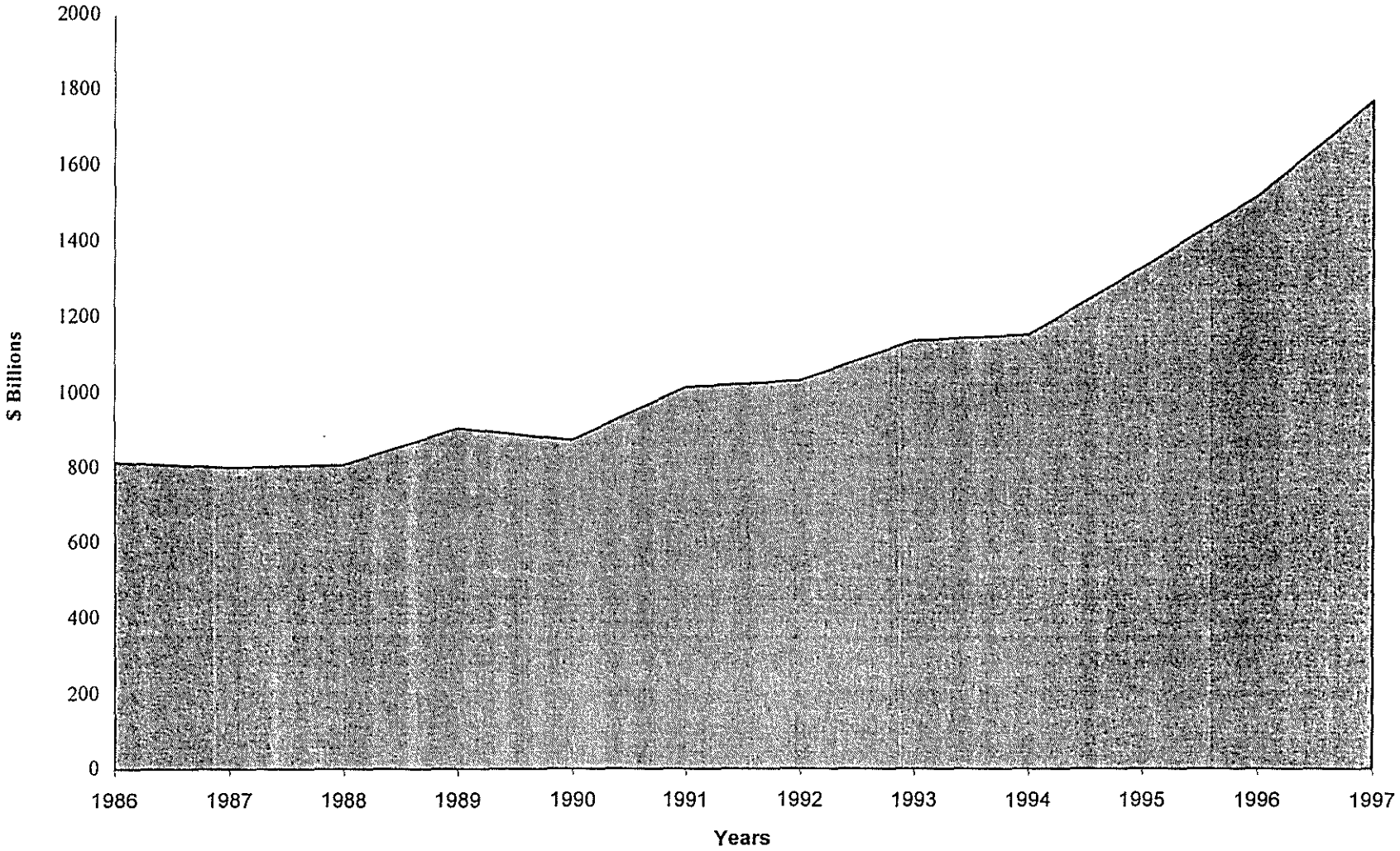
The decline in coverage in the 1980s was concentrated among younger men. The coverage rate among older men has fallen less dramatically, and among women it has risen at some ages and fallen at others.

The decline in pension coverage has occurred at the same time that employers have been shifting from defined benefit plans. Defined benefit plans provided basic plan coverage for 87 percent of private wage and salary workers in 1975.[45] This proportion dropped to 83 percent by 1980 and to 71 percent by 1985. This shifting composition has largely been the result of rapid growth in primary defined contribution plans. Employee stock ownership plans and 401(k) plans have been among the most rapidly growing defined contribution plans.

Figures 3 and 4 utilize data from the Federal Reserve Board's Flow of Funds Accounts to show the value of assets accumulated in defined benefit and defined contribution pension plans. At the end of 1977, the value of assets in each type of plan was equal to approximately $1.8 trillion. The figures also document the rapid accumulation in assets in defined contribution plans compared to that of defined benefit plans over the past 10 years.

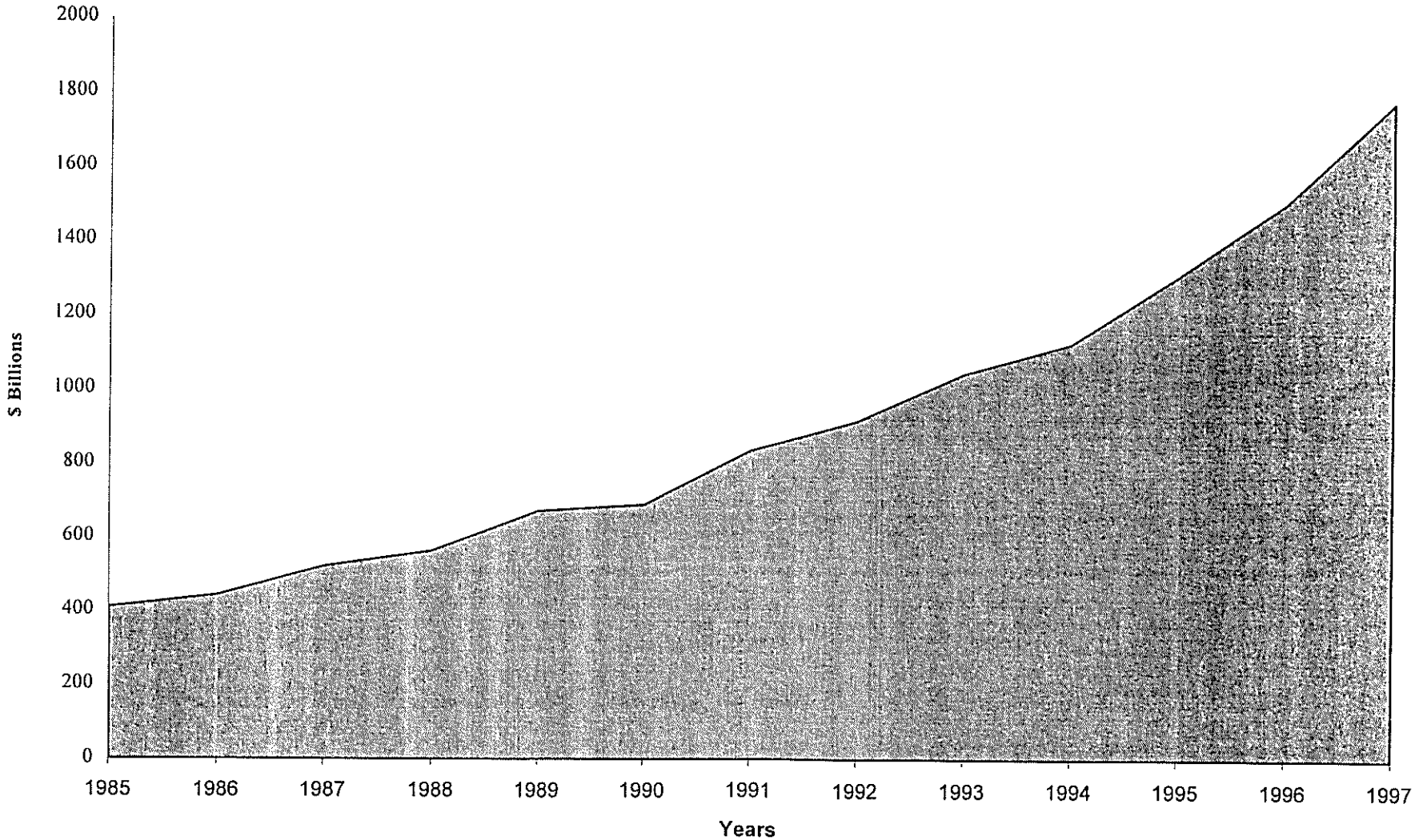
[45] J.A. Turner and D. Beller, *Trends in Pension*, (Washington, D.C.: U.S. Department of Labor), 1989, pp. 65 and 357.

Figure 3.--Total Financial Assets in Defined Benefit Plans, 1985-1997



Source: Federal Reserve Board of Governors, Survey of Consumer Finances.

Figure 4.--Total Financial Assets in Defined Contribution Plans, 1985-1997



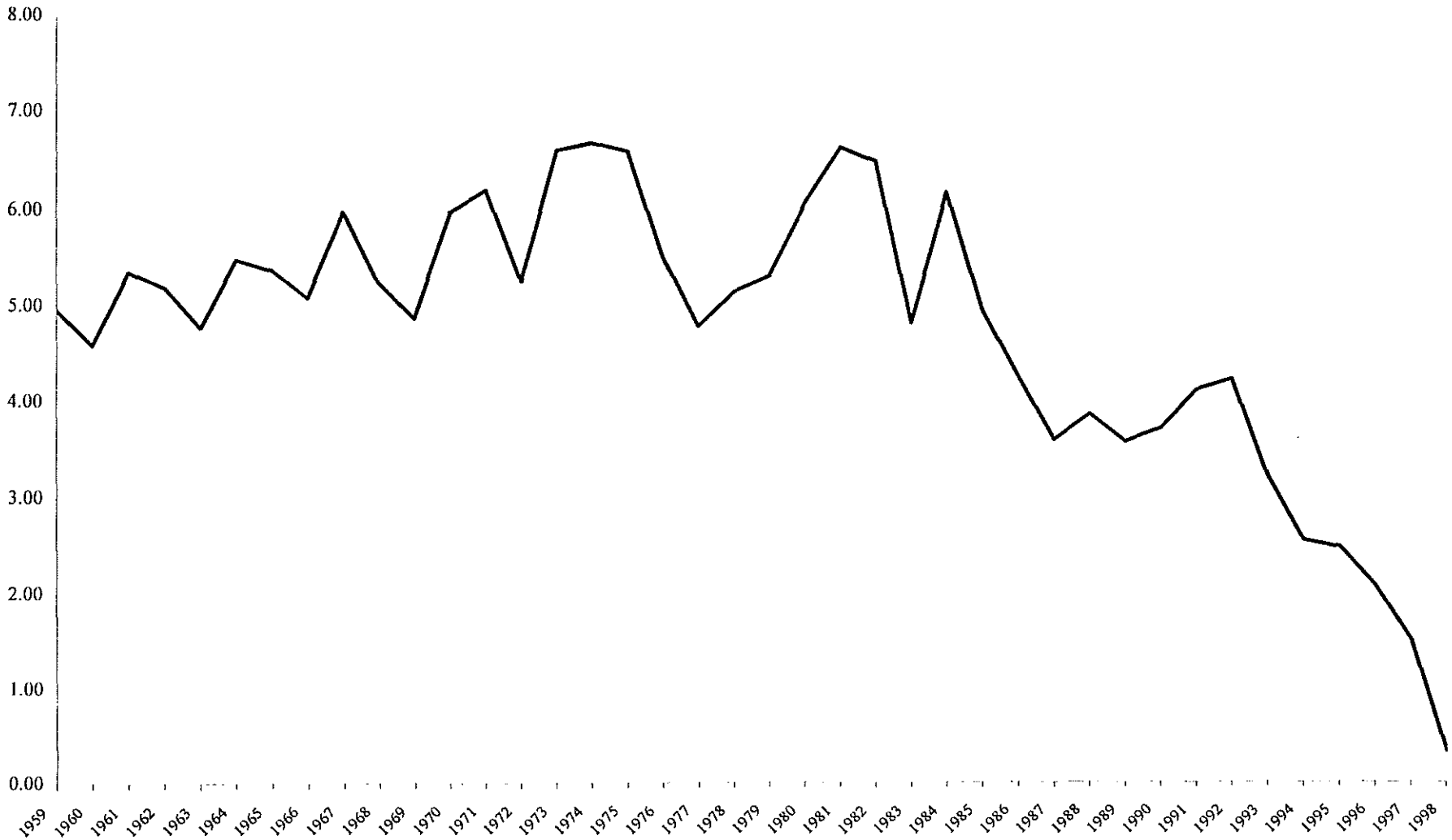
Source: Federal Reserve Board of Governors, Survey of Consumer Finances.

Personal saving

Aggregate saving.--Although coverage by pensions and Social Security is expected to be higher for current workers than it is for current retirees, the saving rate of current workers may be lower than the rate at which current retirees saved during their working lives. This would imply that although two sources of retirement income, Social Security and pension benefits, are expected to be higher for current workers, another source, income from savings, may be lower.

The measure of personal saving used in the National Income and Product Accounts attributes all corporate pension contributions and earnings to the household sector. Thus, the increased pension coverage is already included in the measure of household saving. Table 2, above, and Figure 5, show that personal saving has been declining over the past 15 years. Private saving, which includes the saving of business, and which may provide a better measure of total households saving since businesses are ultimately owned by household, exhibits the same downward trend. Thus, the saving of the current generation of workers for their retirement seems to be low relative to the past. On the other hand, the National Income and Product Accounts measures of saving measure only cash flows not consumed. The purpose of saving for retirement is to accumulate wealth which can be drawn upon in retirement. If, as in the past few years, the market value of assets increases, adequate wealth accumulation may be attained with relatively low saving rates.

Figure 5.--Personal Saving as a Percentage of GDP, 1959-1998

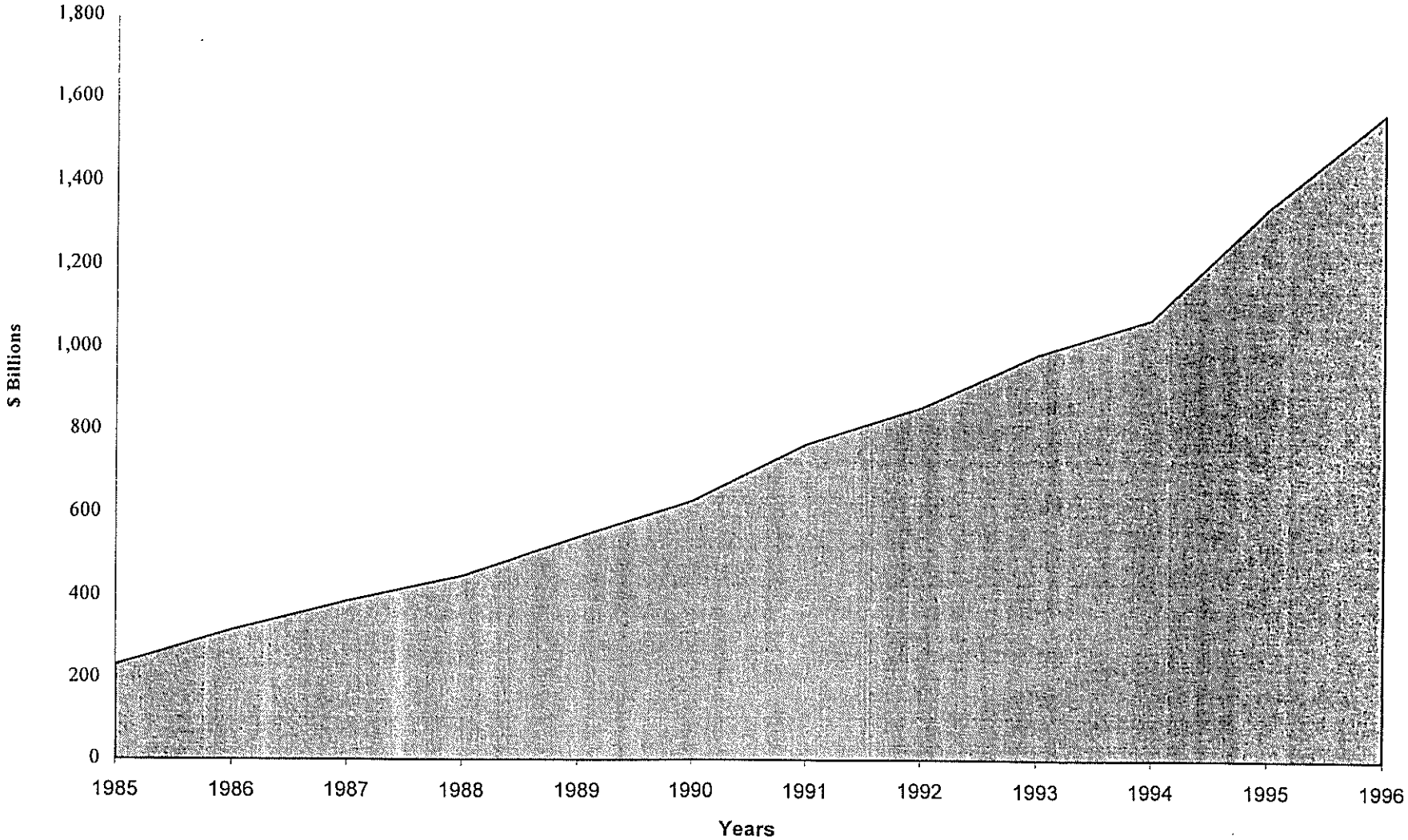


Retirement saving of individuals.--It is difficult to determine how much saving outside of qualified plans is "retirement saving." Contributions to IRAs represent one measure of such non-pension plan retirement saving. Assets within IRAs have grown substantially over the past 10 years. Figure 6 below shows that IRA balances, approximately $1.6 trillion in 1996, are nearly equal in size to the asset balances in both defined benefit and defined contribution plan. (See Figures 3 and 4 above.)

The growth of these balances is impressive in its magnitude, particularly given the relatively modest contributions of recent years. Table 9, below, reports IRA contributions between 1979 and 1996. Deductible IRAs have been very popular with taxpayers. As Table 9 reports, contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs. This represented almost 20 percent of personal saving for that year.

In addition to annual contributions, the current value of IRA balances, as reported in Figure 6, is comprised of balances rolled over into IRAs from qualified plans and increases in the market valuation of IRA investments.

Figure 6.--Value of Assets in IRAs, 1985-1996



Source: Franstein, Employee Benefits Research Institute, 1998.

Table 9.–IRA Participation, 1980-1996

Year	Returns claiming IRA deduction (millions)	Percentage of all returns (percent)	Deductions claimed ($ billions)
1979	2.5	2.6	3.2
1980	2.6	2.7	3.4
1981	3.4	3.6	4.8
1982	12.0	12.6	28.3
1983	13.6	14.1	32.1
1984	15.2	15.3	35.4
1985	16.2	15.9	38.2
1986	15.5	15.1	37.8
1987	7.3	6.8	14.1
1988	6.4	5.8	11.9
1989	5.8	5.2	10.8
1990	5.2	4.6	9.9
1991	4.7	4.1	9.0
1992	4.5	3.9	8.7
1993	4.4	3.8	8.5
1994	4.3	3.7	8.4
1995	4.3	3.6	8.3
1996	4.4	3.6	8.6

Source: Statistics of Income.

As with pension coverage, IRA coverage is not universal. Tables 10 and 11 summarize information on IRA participation in 1985 and 1996. Some have expressed concern about the distribution of taxpayers who contribute to IRAs. The concern is two-fold. First, unequal participation may lead to some taxpayers having accumulated substantial wealth for retirement while other taxpayers have accumulated little wealth. Second, because IRA contributions receive preferential tax treatment, the distribution of the tax expenditure may be viewed as inequitable. In 1985, 71 percent of all returns reporting IRA contributions had AGI below $50,000, and 29 percent had AGI of $50,000 or above. However, taxpayers with AGI of $50,000 or above represented only 8 percent of all returns eligible for IRAs. Thus, although many lower-income individuals contributed to IRAs, most did not, whereas most taxpayers with AGI of $50,000 or above did contribute when eligible. Taxpayers with AGI of $50,000 or above were more than four times as likely to contribute to an IRA than were taxpayers with AGI below $50,000--61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported IRA contributions. On the other hand, the data for 1985 or 1996 represent one-year snapshots of IRA contributions. If the earning power of young individuals increases over time, an individual who did not contribute to an IRA when earning $20,000 per year may later contribute when earning $40,000 per year.

Higher income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 29 percent of all IRA contributors in 1985, but accounted for more than 35 percent of IRA contributions. In 1996, taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 25 percent of all IRA contributors, but accounted for approximately 34 percent of IRA contributions.

Because the value of the IRA is the effective exemption of the earnings from tax, the higher a taxpayer's marginal tax rate, the more valuable the ability to invest through an IRA. Because people in higher income classes generally have higher tax rates, the value of their IRA is larger than the value of IRAs for taxpayers in lower income classes. However, the value of the IRA depends on tax rates throughout the period the IRA is held, and not just the marginal tax rate in the year the contribution is made.

Table 10.–IRA Participation By Income Class, 1985

Adjusted gross income class	Returns reporting IRA contributions		
	Number in millions	Percent of eligible returns[1]	Contri-butions ($ billions)
All classes	16.2	17.8	38.2
Under $10,000	0.6	2.3	1.1
$10,000 to $30,000	5.1	13.6	9.7
$30,000 to $50,000	5.7	32.9	13.5
$50,000 to $75,000	3.0	56.5	8.7
$75,000 to $100,000	0.9	74.1	2.7
Over $100,000	0.8	76.1	2.6

[1] Eligible taxpayers include self-employed persons as well as wage and salary employees. However, taxpayers whose income consists solely of interest income, for example, are ineligible to contribute to IRAs.

Source: Internal Revenue Service, *1985 Statistics of Income.*

Table 11.–IRA Participation By Income Class, 1996

Adjusted gross income class	Returns reporting IRA contributions		
	Number in millions	Percent of returns with earned income[1]	Contri-butions ($ billions)
All classes	4.4	4.1	8.6
Under $10,000	0.3	1.1	0.4
$10,000 to $30,000	1.6	4.3	2.8
$30,000 to $50,000	1.4	6.9	2.4
$50,000 to $75,000	0.5	3.5	1.1
$75,000 to $100,000	0.2	4.5	0.7
Over $100,000	0.4	6.6	1.1

[1] Because of the income limitations enacted by the Tax Reform Act of 1986, not all taxpayers with earned income are eligible to make deductible contributions to IRAs.

Source: Internal Revenue Service, *1996 Statistics of Income.*

It is too soon to assess the effects that the Taxpayer Relief Act of 1997 may have on IRA participation and retirement asset accumulation. Tables 12a and 12b, below, presents the Joint Committee on Taxation staff estimates of the eligibility of taxpayers to make deductible IRA contributions under present law for 1999. The percentage of taxpayers eligible to make deductible IRA contributions differs modestly by filing status. Among married couples filing joint returns, 58 percent are eligible for up to a $4,000 deductible contribution, an additional 15 percent are eligible for up to a $2,000 deductible contribution, and approximately 20 percent are ineligible to make a deductible contribution. Among single filers and head of household filers, only 14 percent are ineligible to make a deductible contribution.

Table 12a.–Eligibility of Taxpayers with Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1999 Returns (Returns with Earned Income for Joint Returns)

AGI	Returns	Percent eligible for full deduction for both spouses	Percent eligible for full deduction for one spouse only	Percent in phaseout range	Percent not eligible for any IRA deduction
Less than $10,000	2,987	100.0	0.0	0.0	0.0
$10,000 to $20,000	4,442	100.0	0.0	0.0	0.0
$20,000 to $30,000	4,728	100.0	0.0	0.0	0.0
$30,000 to $40,000	4,627	100.0	0.0	0.0	0.0
$40,000 to $50,000	4,985	97.3	0.0	2.7	0.0
$50,000 to $75,000	10,275	24.3	26.1	32.1	17.4
$75,000 to $100,000	6,163	13.7	40.7	0.0	45.7
$100,000 to $200,000	5,307	19.6	27.0	2.7	50.7
Over $200,000	1,821	15.7	0.0	0.0	84.3
Total	45,336	58.0	14.6	7.9	19.5
Average dollars eligible per return		$3,803	$1,997	$2,685	

Source: Joint Committee on Taxation staff estimates.

Table 12b.–Eligibility of Taxpayers with Earned Income to Make Deductible IRA Contributions Under Present Law, Projected 1999 Returns (Returns with Earned Income For Other Filers)

AGI	Returns	Percent eligible for full deduction	Percent in phaseout range	Percent not eligible for any IRA deduction
Less than $10,000	22,146	100.0	0.0	0.0
$10,000 to $20,000	15,766	100.0	0.0	0.0
$20,000 to $30,000	11,821	99.9	0.1	0.0
$30,000 to $40,000	7,517	39.9	60.1	0.0
$40,000 to $50,000	5,309	23.9	8.6	67.4
$50,000 to $75,000	5,301	17.6	0.0	82.4
$75,000 to $100,000	1,253	12.2	0.0	87.8
$100,000 to $200,000	863	16.2	0.0	83.8
Over $200,000	222	13.0	0.0	87.0
Total	40,188	78.7	7.1	14.2
Average dollars eligible per return		$1,915	$1,050	

Source: Joint Committee on Taxation staff estimates.

Other authors have noted that even the taxpayers with low income who did contribute to IRAs owned more financial assets than other low-income taxpayers and that, therefore, IRA contributors may not be representative of taxpayers in general. Table 13 presents information on the assets of households with IRAs compared to the assets of households without IRAs. For each income category, the table reports the gross financial asset holdings and non-retirement asset holdings of the median (50th percentile) household.[46] As the table details, families with IRAs have larger holdings of financial assets than do families without IRAs. However, it is also the case that families with IRAs have larger holdings of financial assets than do families without IRAs even when all IRA and pension assets are excluded. Part of the reason that IRA contributors have larger holdings of assets than noncontributors is that contributors to IRAs tend to be older than noncontributors, and older taxpayers have been accumulating assets longer.

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[46] "Gross financial assets" reports only the "asset side" of the family's balance sheet. That is, these figures do not net out the value of any of the family's financial liabilities such as mortgage or consumer debt. "Gross financial assets less retirement assets" subtracts IRA and defined contribution plan asset balances from reported gross financial assets. Neither figure includes a calculation of the value of any accrued defined benefit pension plan benefits.

Table 13.–Estimated Median Financial Assets of Families With IRAs and Families Without IRAs, 1995

Income	Families with IRAs		Families without IRAs	
	Gross financial assets[1]	Gross financial assets less retirement assets[2]	Gross financial assets[1]	Gross financial assets less retirement assets[2]
Less than $10,000	$56,150	33,080	$300	$300
$10,000 to $20,000	49,495	18,000	1,505	1,200
$20,000 to $30,000	45,850	23,850	4,505	2,500
$30,000 to $40,000	51,875	26,800	9,000	4,450
$40,000 to $50,000	81,000	38,000	11,400	6,050
$50,000 to $75,000	118,000	68,300	33,650	17,800
$75,000 to $100,000	181,000	99,600	53,750	33,750
$100,000 and over	1,570,000	1,200,000	1,385,500	1,350,000

Source: Congressional Budget Office tabulations of the Federal Reserve Board of Governors 1995 Survey of Consumer Finances.

[1] "Gross financial assets" reports only the "asset side" of family's balance sheet. These figures do not net off the value of any of the family's financial liabilities such as mortgage or consumer debt.

[2] Gross financial assets less IRA balances and value of defined contribution pension plan assets. Does not include information regarding the accrued value of any defined benefit pension plan benefits.

Estimates of saving rate adequacy.--The Congressional Budget Office ("CBO") reported that while the saving rate of current workers appears low relative to the past, this may not imply that the level of savings is inadequate for retirement. That CBO study concludes that the so-called "baby boom" generation appears to be accumulating assets at a rate equivalent to that of their parents who are currently retired. The CBO concludes that the continued increase in real wages, the fact that baby boomers are more highly educated than their parents, and the increased participation of women in the labor force portend "increases in household incomes of baby boomers in retirement."[47] Some have criticized the conclusion of this study as too optimistic. Critiques note that finding that baby boomers have accumulated approximately the same amount of assets as had their parents at a similar age does not bode well for retirement income. Having the same amount of assets would imply only the potential for the same amount of income as experienced by current retirees, and as incomes grow this would imply future retirees would be less well off compared to the rest of society than are current retirees. Critics also note that current retirees benefitted from increases in Social Security benefits and unexpected capital gains on housing that the baby boomers may not reasonably expect to experience.[48] All studies of this question have emphasized the important difference within the so-called baby boom generation. Most studies note that those with the least education appear to be least well prepared for retirement in terms of accumulating private assets. Some studies suggest that the first cohort of the baby boom generation is likely to be better prepared for retirement than the last cohort of the baby boom generation.[49]

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[47] Congressional Budget Office, "Baby Boomers in Retirement: An Early Perspective," September 1993, p. xiv. Also see, Joyce Manchester, "Baby Boomers in Retirement: An Early Perspective," in Dallas Salisbury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

[48] B. Douglas Bernheim, "Adequacy of Savings for Retirement and the Role of Economic Literacy," in Dallas Salibury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994. Also see Laurence Kotlikoff and Alan J. Auerbach, "U.S. Fiscal and Savings Crises and Their Impact for Baby Boomers" in the same volume. Bernheim and Kotlikoff and Auerbach project potential consumption paths of baby boomers based on their current accumulation of assets and consumption behavior. Both studies conclude that baby boomer saving is, on average, inadequate for that generation to maintain its standard of living in retirement. Bernheim estimates that, holding constant their participation in qualified plans, baby boomer non-retirement plan saving is at one-third the rate necessary to maintain pre-retirement consumption.

[49] For a brief review of this literature see Daniel B. Radner, "The Retirement Prospects of the Baby Boom Generation," *Social Security Bulletin*, 61, 1998, pp. 3-19.

3. Increased retirement costs

Finally, it is possible that the need for retirement income is increasing over time. Increases in life expectancies and trends toward earlier retirement increase the number of years in retirement and therefore increase the need for saving. Furthermore, the normal retirement age for social security was changed in 1983. For those born in 1937 or earlier, the normal retirement age is 65 years old. Thus, in 1999, the normal retirement for Social Security (the age at which retirees receive full benefits) is 65. For those individuals born in 1960 or later, the normal retirement age is 67 years old. That is, by 2027, the normal retirement age will be 67 years. If the increase in the normal retirement age means that individuals will be working more years, then current saving need not adjust. However, if the historical trend toward earlier retirement continues, then the increase in normal retirement age for receipt of full social security benefits means that individuals should increase their retirement saving.

Similarly, increased life expectancies and rapid medical cost inflation increase the probability of large medical expenses. Out-of-pocket medical expenditures for the elderly have been steadily increasing over the last 15 years. Also, many people have noted that the probability of an individual requiring long-term care some time in their lifetime has been increasing.

PART TWO: PRESENT LAW AND BACKGROUND ON FEDERAL TAX PROVISIONS RELATING TO HEALTH AND LONG-TERM CARE

I. PRESENT LAW AND LEGISLATIVE BACKGROUND

A. Exclusion from Income and Wages for Employer-Provided Health Care

Present Law

In general, employer contributions to an accident or health plan are excludable from an employee's income (sec. 106 of the Code). This exclusion for employer-provided health coverage also generally applies to coverage provided to former employees. In the case of a self-insured medical reimbursement plan, the exclusion is conditioned on the coverage being provided under a plan meeting certain nondiscrimination requirements (sec. 105(h)). Insured health plans are generally not subject to nondiscrimination rules. Employer-provided accident or health coverage is generally excludable from wages for employment tax purposes as well without regard to whether the coverage is provided on a nondiscriminatory basis (sec. 3121(a)(2)).

Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care (as defined in sec. 213) or to the extent the benefits constitute payments for the permanent loss of use of a member or function of the body or permanent disfigurement and are computed with reference to the nature of the injury and without regard to the period the employee is absent from work (sec. 105).[50]

Legislative Background

In 1943, the Internal Revenue Service ruled that employer contributions to group health insurance policies were not taxable to the employee. Employer contributions to individual health insurance policies, however, were declared to be taxable income in an IRS revenue ruling in 1953.

Section 106 of the Internal Revenue Code, enacted in 1954, reversed the 1953 IRS ruling. As a result, employer contributions to all accident or health plans generally are excluded from gross income and therefore are not subject to tax. In addition, section 105 of the Code provides that benefits received under an employer's accident or health plan generally are not included in the employee's income.

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[50] The Code also provides an exclusion for amounts received under workmen's compensation acts for personal injuries or sickness and damages received on account of personal injuries or sickness (sec. 104).

The provision relating to self-insured medical reimbursement plans was added by the Revenue Act of 1978.

B. Employer Deduction for Health Care for Employees

Present Law

Under present law, amounts paid or accrued by an employer within a taxable year for a sickness, accident, hospitalization, medical expense, or similar health plan for its employees are generally deductible as ordinary and necessary business expenses under section 162 of the Code. The deduction is available provided the amounts are used to pay accident and health insurance premiums or to pay or reimburse benefits directly. Amounts paid for premiums are not deductible if the proceeds of the policy are payable to the employer rather than the employee. The timing of the deduction is based on the employer's method of accounting. Under the cash method, the expenses are deductible for the taxable year for which they were paid. Under the accrual method, the expenses are deductible for the taxable year in which all events have occurred to determine the fact and amount of the expenses.

Contributions by an employer to a welfare benefit fund are not deductible under the usual income tax rules (sec. 162), but if they otherwise would be deductible under the usual rules (e.g., if they are ordinary and necessary business expenses), the contributions are deductible within limits for the taxable year in which such contributions are made to the fund. A welfare benefit fund is, in general, any fund that is part of a plan of an employer, and through which the employer provides welfare benefits (i.e., benefits other than pension benefits) to employees or their beneficiaries.

The amount of the deduction otherwise available to an employer for a contribution to a welfare benefit fund for any taxable year may not exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) the addition (within limits) to a qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund.[51]

A qualified asset account under a welfare benefit fund is an account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. Under present law, an account limit is provided for the amount in a qualified asset account for any year.

The account limit for any taxable year may include a reserve to provide certain post-retirement medical and life insurance benefits. This limit allows amounts reasonably necessary to

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[51] This limit does not apply to collectively bargained plans, or plans maintained by 10 or more employers.

accumulate reserves under a welfare benefit plan so that the liabilities for post-retirement medical and life insurance benefits with respect to a group of employees can be prefunded.

Each year's computation of contributions with respect to post-retirement medical benefits is to be made under the assumption that the medical benefits provided to future retirees will have the same costs as medical benefits currently provided to retirees. Because the reserve is computed on the basis of the current year's medical costs, neither future inflation nor future changes in the level of utilization may be taken into account until they occur.

In the case of an employee who is a "key employee" (as defined in sec. 416), a separate account is required to be established and maintained on a per-participant basis, and benefits provided to such employee (and his or her spouse and dependents) are payable only from the separate account. Contributions to the separate account of a key employee are considered annual additions to a defined contribution plan for purposes of the limits on contributions and benefits applicable to retirement plans (sec. 415), except that the 25-percent-of-compensation limits (sec. 415(c)(1)(B)) does not apply.

Under present law, if an employer maintains a welfare benefit fund that provides a disqualified benefit during any taxable year, the employer is subject to an excise tax equal to 100 percent of the disqualified benefit. A disqualified benefit includes (1) a benefit provided to a key employee other than from a separate account required to be established for such an employee, (2) any post-retirement medical or life insurance benefit that is provided in a discriminatory manner, and (3) any portion of a welfare benefit fund reverting to the employer.

Legislative Background

The provisions relating to employer deductions for amounts contributed to welfare benefit plans were added by the Deficit Reduction Act of 1984.

C. Cafeteria Plans and Flexible Spending Arrangements

Present Law

Cafeteria plans

In general

Under present law, compensation generally is includible in gross income when actually or constructively received. An amount is constructively received by an individual if it is made available to the individual or the individual has an election to receive such amount. Under one exception to the general principle of constructive receipt, amounts are not included in the gross income of a participant in a cafeteria plan described in section 125 of the Code solely because the participant may elect among cash and certain employer-provided qualified benefits under the plan. This constructive receipt exception is not available if the individual is permitted to revoke

a benefit election during a period of coverage in the absence of a change in family status or certain other events.

In general, a qualified benefit is a benefit that is excludable from an employee's gross income by reason of a specific provision of the Code. Thus, employer-provided accident or health coverage, group-term life insurance coverage (whether or not subject to tax by reason of being in excess of the dollar limit on the exclusion for such insurance), and benefits under dependent care assistance programs may be provided through a cafeteria plan. However, a cafeteria plan may not provide qualified scholarships or tuition reduction (sec. 117), educational assistance (sec. 127), miscellaneous employer-provided fringe benefits (sec. 132) or long-term care insurance (sec. 7702B). In addition, a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement (sec. 401(k)).

A cafeteria plan must be in writing, must include only employees (including former employees) as participants, and must satisfy certain nondiscrimination requirements. An employer that maintains a cafeteria plan is required to file an annual return relating to such plan.

The cafeteria plan exception from the principle of constructive receipt generally also applies for employment tax (FICA and FUTA) purposes.[52]

Nondiscrimination rules

The exception to the constructive receipt principle provided for cafeteria plans does not apply to highly compensated individuals if the plan discriminates in favor of such individuals as to eligibility to participate or as to contributions or benefits under the plan. A plan is not discriminatory as to eligibility if the plan benefits a nondiscriminatory classification of employees and requires no more than 3 years of employment as a condition of participation. Special rules apply for determining whether a plan that provides health coverage is discriminatory with respect to contributions and benefits. In addition, a plan is deemed not to be discriminatory if the plan is maintained pursuant to a collective bargaining agreement.

For purposes of these nondiscrimination requirements, a highly compensated individual is an officer, a shareholder owning more than 5 percent of the employing firm, a highly compensated individual (determined under the facts and circumstances of the case), or a spouse or dependent of the above individuals.

In the case of key employees, the exception to the constructive receipt principle does not apply if the qualified benefits provided under the plan to such employees exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. A key employee is defined under the top-heavy rules applicable to qualified pension plans (sec. 416).

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[52] Elective contributions under a qualified cash or deferred arrangement that is part of a cafeteria plan are subject to employment taxes.

Flexible spending arrangements

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. An FSA may be part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage). FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement (sec. 401(k)). According to proposed Treasury regulations, a cafeteria plan would permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[53] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[54] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[55]

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[53] Prop. Treas. Reg. 1.125-2 Q&A-5(a).

[54] Prop. Treas. Reg. 1-125-2 Q&A-7(b).

[55] Prop. Treas. Reg. 1-125-2 Q&A-7(c).

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage), (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year, (3) only reimburse medical expenses which meet the definition of medical care under section 213(d) of the Code, (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan, (5) reimburse medical expenses which are incurred during the participant's period of coverage, and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[56]

Legislative Background

The Employee Retirement Income Security Act of 1974 ("ERISA") provided that an employer contribution made before January 1, 1977, to a cafeteria plan in existence on June 27, 1974, was required to be included in an employee's gross income only to the extent that the employee actually elected taxable benefits. If a plan did not exist on June 27, 1974, the employer contribution was to be included in income to the extent the employee could have elected taxable benefits. The Revenue Act of 1978 set up permanent rules for plans that offer an election between taxable and nontaxable benefits.

The Deficit Reduction Act of 1984 clarified the types of employer-provided benefits that could be provided through a cafeteria plan, added a 25-percent concentration test, and required annual reporting to the IRS by employers.

The Tax Reform Act of 1986 also modified the rules relating to cafeteria plans in several respects.

D. Medical Savings Accounts

Present Law

In general

Present law provides favorable tax treatment for medical savings accounts ("MSAs"). Within limits, contributions to an MSA are deductible in determining adjusted gross income ("AGI") if made by an eligible individual and are excludable from gross income and wages for

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[56] Prop. Treas. Reg. 1-125-2 Q&A-7(b).

employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are includible in income. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible plan regardless of the size of the entity for which the individual performs services.[57]

An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. In determining whether an employer is a small employer, a preceding year is not taken into account unless the employer was in existence throughout such year. In the case of an employer that was not in existence throughout the first preceding year, the determination of whether the employer has no more than 50 employees is based on the average number of employees that the employer reasonably expects to employ on business days in the current year. In determining the number of employees of an employer, controlled groups of corporations (sec. 414(b)), unincorporated trades or businesses under common control (sec. 414(c)), affiliated service groups (sec. 414(m)), and certain businesses as provided in regulations (sec. 414(o)) are treated as a single employer.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage, described below). In the case of an employee, contributions can be made to an MSA either by the individual or by the individual's employer. However, an individual is not eligible to make contributions to an MSA for a year if any employer contributions are made to an MSA on behalf of the individual for the year. Similarly, if the individual's spouse is covered under the high deductible plan covering such individual and the spouse's employer makes a contribution to an MSA for the spouse, the individual may not make MSA contributions for the year. For example, suppose individual A works for a small employer and is covered under a high deductible plan that covers A and her spouse, B. A's employer makes a contribution for a year to an MSA for A. B is not entitled to make contributions to an MSA for that year.

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than a plan that provides certain permitted coverage, described below). A self-employed

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[57] Self-employed individuals include more than 2-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse).

An individual with other coverage in addition to a high deductible plan is still eligible for an MSA if such other coverage is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Permitted insurance is: (1) Medicare supplemental insurance; (2) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (3) insurance for a specified disease or illness; and (4) insurance that provides a fixed payment for hospitalization.

If a small employer with an MSA plan (i.e., the employer or its employees made contributions to an MSA) ceases to become a small employer (i.e., exceeds the 50-employee limit), then the employer (and its employees) can continue to establish and make contributions to MSAs (including contributions for new employees and employees that did not previously have an MSA) until the year following the first year in which the employer has more than 200 employees. After that, those employees who had an MSA (to which individual or employer contributions were made in any year) can continue to make contributions (or have contributions made on their behalf) even if the employer has more than 200 employees.

Tax treatment of and limits on contributions

Individual contributions to an MSA are deductible (within limits) in determining AGI (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. No deduction is allowed to any individual for MSA contributions if such individual is a dependent on another taxpayer's tax return.

In the case of a self-employed individual, the deduction cannot exceed the individual's earned income from the trade or business with respect to which the high deductible plan is established. In the case of an employee, the deduction cannot exceed the individual's compensation attributable to the employer sponsoring the high deductible plan in which the individual is enrolled.

The maximum annual contribution that can be made to an MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage. No other dollar limits on the maximum contribution apply. The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month.

Contributions for a year can be made until the due date for the individual's tax return for the year (determined without regard to extensions).

Comparability rule for employer contributions

If an employer provides high deductible health plan coverage coupled with an MSA to employees and makes employer contributions to the MSAs during a calendar year, the employer must make available a comparable contribution on behalf of all employees with comparable coverage during the same coverage period in the calendar year. Contributions are considered comparable if they are either of the same dollar amount or the same percentage of the deductible under the high deductible plan. If an employee is employed for only a portion of the calendar year, a contribution to the MSA of such employee is treated as comparable if it is an amount which bears the same ratio to the comparable contribution as the portion of the year he or she is employed bears to the calendar year. The comparability rule is applied separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week). No restrictions are placed on the ability of the employer to offer different plans to different groups of employees. The comparability rule does not restrict contributions that can be made to an MSA by a self-employed individual.

If employer contributions do not comply with the comparability rule during a calendar year, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to MSAs of the employer for the year. The excise tax is designed as a proxy for the denial of employer contributions. In the case of a failure to comply with the comparability rule which is due to reasonable cause and not to willful neglect, the Secretary may waive part or all of the tax imposed to the extent that the payment of the tax would be excessive relative to the failure involved.

For purposes of the comparability rule, employers under common control are aggregated in the same manner as in determining whether the employer is a small employer. The comparability rule does not fail to be satisfied in a year if the employer is precluded from making contributions for all employees with high deductible plan coverage because the employer has more than 200 employees or due to operation of the cap during the initial 4-year period.

Definition of high deductible plan[58]

A high deductible plan is a health plan with an annual deductible of at least $1,550 and no more than $2,300 in the case of individual coverage and at least $3,050 and no more than $4,600 in the case of family coverage. In addition, the maximum out-of-pocket expenses with

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[58] The Public Health Service Act provides that health maintenance organizations may offer high deductible plans (as defined under the Internal Revenue Code provisions relating to MSAs). Thus, providing they are otherwise eligible, an individual with a high deductible plan through an HMO is eligible for an MSA.

respect to allowed costs (including the deductible) must be no more than $3,050 in the case of individual coverage and no more than $5,600 in the case of family coverage. The dollar amounts are indexed for inflation in $50 dollar increments.

A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Tax treatment of MSAs

Earnings on amounts in an MSA are not currently includible in income.

Taxation of distributions

Distributions from an MSA for the medical expenses of the individual and his or her spouse or dependents are generally excludable from income.[59] However, in any year for which a contribution is made to an MSA, withdrawals from an MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[60] This rule is designed to ensure that MSAs are in fact used in conjunction with a high deductible plan, and that they are not primarily used by other individuals who have health plans that are not high deductible plans.

For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than qualified long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

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[59] This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

[60] The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even if for an individual who is not an eligible individual.

Estate tax treatment

Upon death, any balance remaining in the decedent's MSA is includible in his or her gross estate.

If the account holder's surviving spouse is the named beneficiary of the MSA, then, after the death of the account holder, the MSA becomes the MSA of the surviving spouse and the amount of the MSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction provided in Code section 2056. The MSA qualifies for the marital deduction because the account holder has sole control over disposition of the assets in the MSA. The surviving spouse is not required to include any amount in income as a result of the death; the general rules applicable to MSAs apply to the surviving spouse's MSA (e.g., the surviving spouse is subject to income tax only on distributions from the MSA for nonmedical purposes). The surviving spouse can exclude from income amounts withdrawn from the MSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.

If, upon death, the MSA passes to a named beneficiary other than the decedent's surviving spouse, the MSA ceases to be an MSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of MSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in income is reduced by the amount in the MSA used, within one year of the death, to pay qualified medical expenses incurred prior to the death. As is the case with other MSA distributions, whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred. In computing taxable income, the beneficiary may claim a deduction for that portion of the Federal estate tax on the decedent's estate that was attributable to the amount of the MSA balance (calculated in accordance with the present-law rules relating to income in respect of a decedent set forth in sec. 691(c)).

If there is no named beneficiary for the decedent's MSA, the MSA ceases to be an MSA as of the date of death, and the fair market value of the assets in the MSA as of such date are includible in the decedent's gross income for the year of the death. This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to MSA assets (e.g., if the surviving spouse is the sole beneficiary of the decedent's estate).

Cap on taxpayers utilizing MSAs

The number of taxpayers benefitting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the 4-year pilot period 1997-2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants) or (2) are employed by a participating employer, would be eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of

individuals who were not covered under a health insurance plan for the six-month period ending on the date on which coverage under a high deductible plan commences are not taken into account.[61] However, if the threshold level is exceeded in a year, previously uninsured individuals would be subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of MSAs established has been well below the threshold level.[62]

End of pilot project

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made MSA contributions of at least $100 in the year 2000.

Self-employed individuals who made contributions to an MSA during the period 1997-2000 also may continue to make contributions after 2000.

Legislative Background

The provisions relating to MSAs were added by the Health Insurance Portability and Accountability Act of 1996.

E. Deduction for Health Insurance Expenses of Self-Employed Individuals

Present Law

Under present and prior law, the tax treatment of health insurance expenses depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid for by the employee's employer. An employer's contributions to a plan providing accident or health coverage for the employee and the employee's spouse and dependents are excludable from an employee's income. The exclusion is generally available in the case of owners of a business who are also employees.

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[61] Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

[62] See discussion in part II.D., below.

Under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership), are entitled to deduct a portion of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents. Self-employed individuals may deduct the amount paid for health insurance as follows: 45 percent in 1999, 50 percent in 2000 and 2001, 60 percent in 2002, 80 percent in 2003 through 2005, 90 percent in 2006, and 100 percent in 2007 and all years thereafter.

The deduction is available with respect to the cost of self insurance as well as commercial insurance. In the case of self insurance, the deduction is not available unless the self-insured plan is in fact insurance (e.g., there is adequate risk shifting) and not merely a reimbursement arrangement. The deduction is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. In addition, no deduction is available to the extent that the deduction exceeds the taxpayer's earned income from self employment. Expenses for health insurance in excess of the deductible amount may be taken into account in determining whether the individual is entitled to an itemized deduction for medical expenses.

Payments for personal injury or sickness through an arrangement having the effect of accident or health insurance (and not merely a reimbursement arrangement) are excludable from income. In order for the exclusion to apply, the arrangement must be insurance (e.g., there must be adequate risk shifting). A self-employed individual who receives payments from such an arrangement can exclude the payments from income.

For purposes of these rules, more than 2-percent shareholders of S corporations are treated the same as self-employed individuals. Thus, they are entitled to the same health insurance deduction.

Legislative Background

The provision relating to the deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986. Under that Act, the deduction was limited to 20 percent of health insurance costs. The Self-Employed Health Insurance Act of 1995 increased the level of deduction from 25 to 30 percent, beginning in 1995. The Health Insurance Portability and Accountability Act of 1996 increased the level of deduction as follows: the deduction is 40 percent in 1997; 45 percent in 1998 through 2002; 50 percent in 2003; 60 percent in 2004; 70 percent in 2005; and 80 percent in 2006 and thereafter. The Taxpayer Relief Act of 1997 increased the level of deduction as described above under present law.

F. Itemized Deduction for Medical Expenses

Present Law

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year (if not reimbursed by insurance or otherwise) for medical care of the taxpayer,

the taxpayer's spouse, and dependents, to the extent that the total of such expenses exceeds 7.5 percent of the taxpayer's adjusted gross income ("AGI").

Under a special rule, premiums paid during the taxable year by a taxpayer before the attainment of age 65 for insurance covering medical care for the taxpayer, his or her spouse, or a dependent after the taxpayer attains the age of 65 are treated as expenses paid during the taxable year for insurance which constitutes medical care if premiums for the insurance are payable (on a level payment basis) under the contract for a period of 10 years or more or until the year in which the taxpayer attains the age of 65 (but in no case for a period of less than 5 years).

Legislative Background

An itemized deduction for unreimbursed medical expenses above a specified floor has been allowed since 1942. From 1954 through 1982, the floor under the medical expense deduction was 3 percent of the taxpayer's AGI; a separate floor of 1 percent of AGI applied to expenditures for medicine and drugs.

In the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the floor was increased to 5 percent of AGI (effective for 1983 and thereafter) and was applied to the total of all eligible medical expenses, including prescription drugs and insulin. TEFRA made nonprescription drugs ineligible for the deduction and eliminated the separate floor for drug costs.

The Tax Reform Act of 1986 increased the floor under the medical expense deduction to 7.5 percent of AGI, beginning in 1987.

Beginning in 1991, The Omnibus Budget Reconciliation Act of 1990 disallowed the medical expense deduction for cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity directly related to a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease.

G. Provisions Relating to Long-Term Care

Present Law

In general

Present law provides favorable tax treatment for qualified long-term care insurance contracts and qualified long-term care services similar to the favorable tax treatment that applies to medical insurance and services and employer-provided accident or health plans.

In general, amounts received under a qualified long-term care insurance contract are excludable from income (subject to an annual dollar cap in the case of per diem contracts). Employer contributions for qualified long-term care insurance are excludable from income,

except that this exclusion does not apply to long-term care insurance or services provided under a cafeteria plan. Up to certain dollar limits, premiums for long-term care insurance are treated as a medical expense for purposes of the itemized deduction for medical expenses, and are deductible under the rules relating to deduction of health insurance expenses for self-employed individuals. Expenses for qualified long-term care services are treated as medical expenses for purposes of the itemized deduction for medical expenses.

Exclusion of long-term care proceeds

Amounts (other than policyholder dividends or premium refunds) received under a qualified long-term care insurance contract generally are excludable from income as amounts received for personal injuries and sickness, subject to a cap of $190 per day, or $69,350 annually (for 1999), on per diem contracts only. The dollar cap is indexed by the medical care cost component of the consumer price index.

Employer-provided long-term care coverage

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan. Thus, employer contributions for long-term care insurance are deductible by the employer. Amounts received from long-term care insurance purchased by the employer are excludable from income (subject to the cap on per diem contracts).

Employer-provided coverage under a long-term care insurance contract is not excludable by an employee if provided through a cafeteria plan; similarly, expenses for long-term care services cannot be reimbursed under a flexible spending arrangement. Thus, employer contributions (other than through a cafeteria plan) for long-term care insurance for the employee, his or her spouse, and his or her dependents (as defined for tax purposes) are excludable from income and wages for employment tax purposes.

Definition of long-term care insurance contract

A long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services and that meets other requirements. The other requirements are that (1) the contract is guaranteed renewable, (2) the contract does not provide for a cash surrender value or other money that can be paid, assigned, pledged or borrowed, (3) refunds (other than refunds on the death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits, and (4) the contract generally does not pay or reimburse expenses reimbursable under Medicare (except where Medicare is a secondary payor, or the contract makes per diem or other periodic payments without regard to expenses).

A contract does not fail to be treated as a long-term care insurance contract solely because it provides for payments on a per diem or other periodic basis without regard to expenses incurred during the period.

State-maintained plans

An arrangement is treated as a qualified long-term care insurance contract if an individual receives coverage for qualified long-term care services under a State long-term care plan, and the terms of the arrangement would satisfy the requirements for a long-term care insurance contract under the provision, were the arrangement an insurance contract. For this purpose, a State long-term care plan is any plan established and maintained by a State (or instrumentality of such State) under which only employees (and former employees, including retirees) of a State or of a political subdivision or instrumentality of the State, and their relatives, and their spouses and spouses' relatives, may receive coverage only for qualified long-term care services. "Relative" is defined as under section 152(a)(1)-(8). No inference was intended with respect to the tax consequences of such arrangements under prior law.

Definition of qualified long-term care services

Qualified long-term care services means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner. Maintenance and personal care services may include meal preparation, household cleaning, and other similar services which the chronically ill individual is unable to perform. It is anticipated that the scope of maintenance and personal care services will be defined in Treasury regulations.

A chronically ill individual is one who has been certified within the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days[63] due to a loss of functional capacity, (2) having a similar level of disability as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services, or (3) requiring substantial supervision to protect such individual from threats to health and

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[63] The 90-day period is not a waiting period. Thus, for example, an individual can be certified as chronically ill if the licensed health care practitioner certifies that the individual will be unable to perform at least 2 activities of daily living for at least 90 days. The certification of an insured as a chronically ill individual may occur at any time, and is intended to take into account the sum of continuous prior days when the insured was chronically ill and future days when the insured is expected to remain chronically ill.

safety due to severe cognitive impairment. Activities of daily living are eating, toileting, transferring, bathing, dressing and continence.[64]

An individual who is physically able but has a cognitive impairment such as Alzheimer's disease or another form of irreversible loss of mental capacity be treated similarly to an individual who is unable to perform (without substantial assistance) at least 2 activities of daily living. Because of the concern that eligibility for the medical expense deduction not be diagnosis-driven, the provision requires the cognitive impairment to be severe. It was intended that severe cognitive impairment mean a deterioration or loss in intellectual capacity that is measured by clinical evidence and standardized tests which reliably measure impairment in: (1) short- or long-term memory; (2) orientation to people, places or time; and (3) deductive or abstract reasoning. In addition, it was intended that such deterioration or loss place the individual in jeopardy of harming self or others and therefore require substantial supervision by another individual.

A licensed health care practitioner is a physician (as defined in sec. 1861(r)(l) of the Social Security Act) and any registered professional nurse, licensed social worker, or other individual who meets such requirements as may be prescribed by the Secretary of the Treasury. A licensed social worker includes any social worker who has been issued a license, certificate, or similar authorization to act as a social worker by a State or a body authorized by a State to issue such authorizations.

Expenses for long-term care services treated as medical expenses

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5 percent of adjusted gross income). For this purpose, amounts received under a qualified long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

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[64] For purposes of determining whether an individual is chronically ill, the number of activities of daily living that are taken into account under the contract may not be less than five. For example, a contract could require that an individual be unable to perform (without substantial assistance) two out of any five of the listed activities. By contrast, a contract does not meet this requirement if it required that an individual be unable to perform two out of any four of the listed activities. This requirement does not apply to the determination of whether an individual is a chronically ill individual either (1) by virtue of severe cognitive impairment, or (2) if the insured satisfies a standard (if any) that is not based upon activities of daily living, as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

For purposes of the deduction for medical expenses, qualified long-term care services do not include services provided to an individual by a relative or spouse (directly, or through a partnership, corporation, or other entity), unless the relative is a licensed professional with respect to such services, or by a related corporation (within the meaning of Code section 267(b) or 707(b)).[65]

Long-term care insurance premiums treated as medical expenses

Long-term care insurance premiums that do not exceed specified dollar limits are treated as medical expenses for purposes of the itemized deduction for medical expenses.[66] The limits (for 1999) are as follows:

In the case of an individual with an attained age before the close of the taxable year of:	The limitation on premiums paid for such taxable years is:
Not more than 40	$ 210
More than 40 but not more than 50	400
More than 50 but not more than 60	800
More than 60 but not more than 70	2,120
More than 70	2,660

These dollar limits are indexed for inflation.

Deduction for long-term care insurance of self-employed individuals

The self-employed health insurance deduction applies to eligible long-term care insurance premiums.

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[65] The rule limiting such services provided by a relative or a related corporation does not apply for purposes of the exclusion for amounts received under a long-term care insurance contract, whether the contract is employer-provided or purchased by an individual. The limitation is unnecessary in such cases because it is anticipated that the insurer will monitor reimbursements to limit opportunities for fraud in connection with the performance of services by the taxpayer's relative or a related corporation.

[66] Similarly, within certain limits, in the case of a rider to a life insurance contract, charges against the life insurance contract's cash surrender value that are includible in income are treated as medical expenses (provided the rider constitutes a long-term care insurance contract).

The deduction for health insurance expenses of a self-employed individual is not available for a month for which the individual is eligible to participate in any subsidized health plan maintained by any employer of the individual or the individual's spouse. The fact that an individual is eligible for employer-subsidized health insurance is not intended to affect the ability of such an individual to deduct long-term care insurance premiums, so long as the individual is not eligible for employer-subsidized long-term care insurance.

Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts apply as if the portion of the contract providing such coverage were a separate contract. The term "portion" means only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value. The guideline premium limitation applicable under section 7702(c)(2) is increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)). In addition, it is anticipated that Treasury regulations will provide for appropriate reduction in premiums paid (within the meaning of sec. 7702(f)(1)) to reflect the payment of benefits under the rider that reduce the cash surrender value of the life insurance contract.

Inclusion of excess long-term care benefits

Long-term care benefits in excess of the annual dollar cap under per diem contracts are includible in gross income. The amount of the dollar cap with respect to any one chronically ill individual (who is not terminally ill) is $190 per day or $69,350 annually (for 1999), reduced by the amount of reimbursements and payments received by anyone for the cost of qualified long-term care services for the chronically ill individual.[67] If more than one payee receives payments with respect to any one chronically ill individual, then everyone receiving periodic payments with respect to the same insured is treated as one person for purposes of the dollar cap. The amount of the dollar cap is utilized first by the chronically ill person, and any remaining amount is allocated in accordance with Treasury regulations. If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of actual costs (in excess of the dollar cap) incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includible in income.

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[67] The dollar cap is also reduced by amounts received with respect to a chronically ill individual under a life insurance contract.

The $190 per day limit is indexed for inflation for increases in the medical care component of the consumer price index.

A payor of long-term care benefits (defined for this purpose to include any amount paid under a product advertised, marketed or offered as long-term care insurance) is required to report to the IRS the aggregate amount of such benefits paid to any individual during any calendar year, and the name, address and taxpayer identification number of such individual. In addition, a payor is required to report the name, address, and taxpayer identification number of the chronically ill individual on account of whose condition such amounts are paid, and whether the contract under which the amount is paid is a per diem-type contract. A copy of the report must be provided to the payee by January 31 following the year of payment, showing the name of the payor and the aggregate amount of benefits paid to the individual during the calendar year. Failure to file the report or provide the copy to the payee is subject to the generally applicable penalties for failure to file similar information reports.

Life insurance company reserves

In determining reserves for insurance company tax purposes, the Federal income tax reserve method applicable for a long-term care insurance contract issued after December 31, 1996, is the method prescribed by the NAIC (or, if no reserve method has been so prescribed, a method consistent with the tax reserve method for life insurance, annuity or noncancellable accident and health insurance contracts, whichever is most appropriate). The method currently prescribed by the NAIC for long-term care insurance contracts is the one-year full preliminary term method. As under prior and present law, however, in no event may the tax reserve for a contract as of any time exceed the amount which would be taken into account with respect to the contract as of such time in determining statutory reserves.

Consumer protection provisions

Long-term care insurance contracts, and issuers of contracts, are required to satisfy certain provisions of the long-term care insurance model Act and model regulations promulgated by the NAIC (as adopted as of January 1993).

The contract requirements relate to disclosure, nonforfeitability, guaranteed renewal or noncancellability, prohibitions on limitations and exclusions, extension of benefits, continuation or conversion of coverage, discontinuance and replacement of policies, unintentional lapse, post-claims underwriting, minimum standards, inflation protection, preexisting conditions, and prior hospitalization. Disclosure and nonforfeiture requirements also apply. The nonforfeiture provision gives consumers the option of selecting reduced paid-up insurance, extended term insurance, or a shortened benefit period in the event a policyholder who elects a nonforfeiture provision is unable to continue to pay premiums. The requirement that insurers offer policyholders a nonforfeiture benefit does not preclude the imposition of a reasonable delay period. The consumer protection provisions that apply with respect to the terms of the contract

apply only for purposes of determining whether a contract is a qualified long-term care insurance contract.

The requirements for issuers of long-term care insurance contracts relate to application forms, reporting requirements, marketing, appropriateness of purchase, format, delivering a shopper's guide, right to return, outline of coverage, group plans, policy summary, monthly reports on accelerated death benefits, and incontestability period. A tax is imposed equal to $100 per insured per day for failure to satisfy these requirements. The consumer protection requirements for issuers of contracts apply with respect to contracts that are qualified long-term care insurance contracts.

An otherwise qualified long-term care insurance contract will not fail to be a qualified long-term care insurance contract solely because it satisfies a consumer protection standard imposed under applicable State law that is more stringent than the analogous standard provided in the Code.

Legislative Background

The provisions relating to long-term care were added by the Health Insurance Portability and Accountability Act of 1996.

H. Group Health Plan Requirements

1. Health care continuation rules

Present Law

The health care continuation rules (commonly referred to as "COBRA" rules, after the Consolidated Omnibus Budget Reconciliation Act of 1985 in which they were enacted) require that most employer-sponsored group health plans must offer certain covered employees and their dependents ("qualified beneficiaries") the option of purchasing continued health coverage in the event of loss of coverage resulting from certain qualifying events. These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, enrollment in Medicare, the bankruptcy of the employer, or the end of a child's dependency under a parent's health plan. The term qualified beneficiary includes individuals who were either the spouse or the dependent of the covered employee at the time of the qualifying event and includes a child born to or placed for adoption with the covered employee during the period of COBRA coverage

In general, the maximum period of COBRA coverage is 18 months. An employer is permitted to charge qualified beneficiaries 102 percent of the applicable premium for COBRA coverage. A tax equal to $100 per day may be assessed against employers (plans in the case of multiemployer plans) for failures to comply with the COBRA rules, subject to certain exceptions and limitations. This tax may be assessed against a person who is responsible (other than in a

capacity as an employee) for administering or providing benefits under a plan and whose act or failure to act caused (in whole or in part) the failure to comply with the COBRA rules.

The 18-month maximum COBRA coverage period is extended to 29 months if the qualified beneficiary was determined under the Social Security Act to have been disabled at the time of the qualifying event and the qualified beneficiary provided notice of such determination to the employer before the end of the 18-month period. The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") clarified that this extended COBRA coverage applies if the disability exists at any time during the first 60 days of initial 18-month COBRA coverage as opposed to requiring the disability to exist at the time of the qualifying event. A qualified beneficiary has 60 days to notify the employer of a disability determination. During the 11-month period of extended COBRA coverage, the qualified beneficiary may be charged 150 percent of the applicable premium.

COBRA coverage may be terminated before the 18-month maximum coverage period in the case of the following events: (1) the employer ceases to maintain any group health plan; (2) the qualified beneficiary fails to pay the premium; (3) the qualified beneficiary becomes covered under another group health plan even if such group health plan contains a preexisting condition limitation or exclusion, provided the preexisting condition limitation or exclusion does not apply to the qualified beneficiary by reason of requirements added by HIPAA restricting the application of preexisting condition limitations and exclusions; or (4) the qualified beneficiary becomes entitled to Medicare.

A group health plan is required to notify each covered employee and the covered employee's spouse of their COBRA rights upon commencement of participation in the plan. Further, the group health plan administrator must notify each qualified beneficiary of their COBRA rights within 14 days after the administrator is notified of the occurrence of a qualifying event.

Legislative Background

The COBRA rules were added by the Consolidated Omnibus Budget Reconciliation Act of 1985. Provisions modifying the COBRA rules were added by the Health Insurance Portability and Accountability Act of 1996.

2. Health Insurance Portability and Accountability Act ("HIPAA") rules

Present Law

HIPAA requirements--in general

Under HIPAA, certain group health plans are subject to certain requirements regarding portability of coverage through limitations on preexisting condition exclusions, prohibitions on denial of coverage based on health status, and guaranteed renewability of health insurance

coverage. An excise tax is imposed with respect to any failure of a group health plan to comply with the requirements.[68] The tax is generally imposed on the employer sponsoring the plan. However, the tax is imposed on the plan in the case of a multiemployer plan and, with respect to violations of the requirements relating to guaranteed renewability, on the arrangement in the case of a multiple employer welfare arrangement.

These group health plan requirements do not apply to governmental plans and plans which on the first day of the plan year cover fewer than 2 current employees. In addition, no tax may be imposed on a small employer (defined as an employer who employed an average of 50 or fewer employees on business days during the preceding calendar year) that provides health care benefits through a contract with an insurer or HMO if the violation is solely because of the coverage offered by the insurer or HMO.

Group health plan requirements

Limitations on preexisting condition exclusions

HIPAA restricts the use of preexisting condition exclusions by group health plans. A preexisting condition exclusion is a limitation or exclusion of benefits relating to a condition, whether physical or mental, based on the fact that the condition was present before the enrollment date, whether or not any medical advice, diagnosis, care, or treatment was recommended or received before that date. Genetic information is not considered a condition in the absence of a diagnosis of the condition related to such information.

HIPAA permits a group health plan to impose a preexisting condition exclusion if the exclusion relates to a condition (whether physical or mental), regardless of the cause of condition, for which medical advice, diagnosis, care, or treatment was recommended or received within the 6-month period ending on the enrollment date. The exclusion may extend to not more than 12 months (18 months for late enrollees) after the enrollment date. The exclusion is reduced by the aggregate of the periods of creditable coverage prior to a break in coverage of at least 63 days. Creditable coverage includes coverage under a group health plan, health insurance coverage, Medicare, a state health benefit risk pool and a public health plan. Enrollment date is defined as the date of enrollment in the plan or coverage or, if earlier, the first day of the waiting period for such enrollment.

Any waiting period or affiliation period runs concurrently with any preexisting condition exclusion period. A preexisting condition exclusion period may not be applied to a newborn, an adopted child, or a child placed for adoption under age 18, so long as the individual becomes covered under creditable coverage within 30 days of birth or adoption or placement for adoption.

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[68] HIPAA also enforces these requirements through the Employee Retirement Income Security Act and the Public Health Service Act, and imposes similar and additional requirements on health insurance issuers.

These exceptions for newborns and certain adopted children do not apply if the individual had a break in coverage longer than a 63-day period. Preexisting condition exclusions may not apply to pregnancies.

A group health plan offering health insurance coverage through an HMO, or an HMO which offers health insurance coverage in connection with a group health plan, may impose an affiliation period only if no preexisting condition exclusion is imposed, the period is imposed uniformly without regard to health status, and does not exceed 2 months for timely enrollment and 3 months for late enrollment. The affiliation period must apply to all new enrollees and beneficiaries. During the affiliation period, the HMO cannot be required to provide health care services or benefits and no premium can be charged to the participant or beneficiary. The affiliation period begins on the enrollment date and runs concurrently with any other applicable waiting period under the plan. An HMO may use alternative methods to address adverse selection as approved by state regulators.

Prohibiting exclusions based on health status

Except as specified below, a group health plan cannot establish rules for eligibility (including continued eligibility) of an individual to enroll under the terms of the plan based on any of the following health-related factors in relation to the individual or a dependent of the individual: health status, medical condition (including both physical and mental illness), claims experience, receipt of health care, medical history, genetic information, evidence of insurability (including conditions arising out of domestic violence), or disability.

The inclusion of evidence of insurability in the definition of health status is intended to ensure, among other things, that individuals are not excluded from health care coverage due to their participation in activities such as motorcycling, snowmobiling, all-terrain vehicle riding, horseback riding, skiing, and other similar activities.

A plan cannot knowingly be designed to exclude individuals and their dependents on the basis of health status. However, generally applicable terms of the plan may have a disparate impact on individual enrollees. For example, a plan may exclude all coverage of a specific condition, or may include a lifetime cap on all benefits, or a lifetime cap on specific benefits. Although individuals with the specific condition would be adversely affected by an exclusion of coverage for that condition, and individuals with serious illnesses may be adversely affected by a lifetime cap on all or specific benefits, such plan characteristics are permitted as long as they are not directed at individual sick employees or dependents.

HIPAA does not require a group health plan to provide particular benefits other than those provided under the terms of the plan or coverage. Nor does it prevent any plan or coverage from establishing limitations or restrictions on the amount, level, extent, or nature of the benefits or coverage for similarly situated individuals enrolled in the plan or coverage. Rules defining any applicable waiting periods for enrollment may not be based on factors related to health status.

A plan cannot single out an individual based on health status or related factors for denial of a benefit otherwise provided other individuals covered under the plan. For example, the plan may not deny coverage for prescription drugs to a particular beneficiary or dependent if such coverage is available to other similarly situated individuals covered under the plan. However, the plan could deny coverage for prescription drugs to all beneficiaries and dependents. The term "similarly situated" means that a plan is permitted to vary benefits available to different groups of employees, such as full-time versus part-time employees or employees in different geographic locations. In addition, a plan may have different benefit schedules for different collective bargaining units.

HIPAA provides that a group health plan cannot require a premium or contribution which is greater than such premium or contribution for a similarly situated individual enrolled in the plan on the basis of any factor relating to the health status of individual or any individual enrolled under the plan as a dependent of the individual. HIPAA does not restrict the amount that an employee may be charged for coverage under a group health plan. The group health plan may establish premium discounts or rebates, or modify otherwise applicable copayments or deductibles in return for adherence to programs of health promotion and disease prevention.

These provisions preclude insurance companies from denying coverage to employees based on health status and related factors that they have traditionally used. In addition, this provision is meant to prohibit insurers or employers from excluding employees in a group from coverage or charging them higher premiums based on their health status and other related factors that could lead to higher health costs. This does not mean that an entire group cannot be charged more. But it does preclude health plans from singling out individuals in the group for higher premiums or dropping them from coverage altogether.

Guaranteed renewability in multiemployer plans and certain multiple employer welfare arrangements

HIPAA provides that a group health plan which is a multiemployer plan or a multiple employer welfare arrangement may not deny an employer continued access to the same or different coverage under the terms of such plan except: (1) for nonpayment of contributions; (2) for fraud; (3) for noncompliance with plan provisions; (4) because the plan is ceasing to offer any coverage in a geographic area; (5) in the case of a network plan, there is no longer any individual enrolled through the employer who lives, resides, or works in the service area of the network plan, and the plan applies this provision uniformly without regard to claims experience or health status-related factors; or (6) due to a failure to meet the terms of an applicable collective bargaining agreement, to renew a collective bargaining agreement or other agreement requiring or authorizing contributions to the plan, or to employ employees covered by such an agreement.

Excise tax on failure to satisfy group health plan requirements

The excise tax on the failure to satisfy the group health plan requirements is generally equal to $100 per day for each day during which a failure occurs until the failure is corrected.

The tax applies separately with respect to each individual affected by the failure. In general, the tax is not imposed if the violation was unintentional and is corrected within 30 days.[69] The maximum tax for unintentional violations that can be imposed generally is the lesser of (1) 10 percent of the employer's payments during the taxable year in which the failure occurred under group health plans (or 10 percent of the amount paid by the multiemployer plan or multiple employer welfare arrangement during the plan year in which the failure occurred for medical care, if applicable), or (2) $500,000. The Secretary of the Treasury may waive all or part of the tax to the extent that payment of the tax would be excessive relative to the failure involved.

Legislative Background

The provisions relating to group health plan requirements were added by the Health Insurance Portability and Accountability Act of 1996.

3. Newborns' and mothers' health protection; mental health parity

Present Law

The Newborns' and Mothers' Health Protection Act of 1996 amended the Employee Retirement Income Security Act ("ERISA") and the Public Health Service Act to impose certain requirements on group health plans with respect to coverage of newborns and mothers, including a requirement that a group health plan cannot restrict benefits for a hospital stay in connection with childbirth for the mother or newborn to less than 48 hours following a normal vaginal delivery or less than 96 hours following a cesarean section. These provisions are effective with respect to plan years beginning on or after January 1, 1998.

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to Provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, but do not apply to benefits for services furnished on or after September 30, 2001.

The Internal Revenue Code requires that group health plans meet certain requirements with respect to limitations on exclusions of preexisting conditions and that group health plans not discriminate against individuals based on health status. An excise tax of $100 per day during the period of noncompliance is imposed on the employer sponsoring the plan if the plan fails to meet these requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or

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[69] In the case of a church plan, this correction is generally extended to 270 days after the date of mailing by the Secretary of the Treasury of a notice of default with respect to a failure to comply with the group health plan requirements.

$500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

Failures to comply with the provisions of the Newborns' and Mothers' Health Protection Act and the Mental Health Parity Act are subject to the excise tax applicable to failures to comply with other group health plan requirements.

Legislative Background

The provision incorporating the provisions of the Newborns' and Mothers' Health Protection Act of 1996 and the Mental Health Parity Act of 1996 relating to group health plans into the Internal Revenue Code was added by the Taxpayer Relief Act of 1997.

I. Other Tax-Related Health Provisions

Under present law, post-retirement medical benefits are generally excludable from the gross income of a plan participant or beneficiary. In addition, an employer may deduct contributions, within limits, made to a welfare benefit fund for retiree health and life insurance benefits of its employees.

Legislative Background

1. Voluntary employees' beneficiary associations ("VEBAs")

Present Law

Under present law, a voluntary employees' beneficiary association ("VEBA") is a tax exempt welfare benefit fund that provides for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, and under which no part of the net earnings of such association may inure (other than through such payments) to the benefit of any private shareholder or individual. In addition the VEBA generally is required to satisfy certain rules prohibiting the provision of benefits on a basis that favors the employer's highly compensated employees.

Although a VEBA generally is exempt from tax, it is taxable on its unrelated business taxable income ("UBTI"). Income set aside to provide for post-retirement medical benefits is considered UBTI. This rule does not apply to a VEBA if substantially all of the contributions to it were made by employers who are exempt from income tax throughout the 5-taxable-year period ending with the taxable year in which the contributions were made. Further, VEBAs maintained pursuant to a collective bargaining agreement and certain employee pay all VEBAs are not subject to UBTI because no account limits apply to such VEBAs.

Legislative Background

The provisions relating to VEBAs were added by the Deficit Reduction Act of 1984.

2. Use of excess pension assets to fund retiree health benefits

Present Law

Under present law, a tax-qualified pension or annuity plan may provide for the payment of sickness, accident, hospitalization and medical expenses for retired employees, their spouses, and their dependents under a separate account method of prefunding post-retirement medical and life insurance benefits provided certain additional qualification requirements are satisfied with respect to the post-retirement medical benefits (sec. 401(h)). First, the medical benefits, when added to any life insurance protection provided under the plan, are required to be incidental to the retirement benefits provided by the plan. The medical benefits are considered incidental or subordinate to the retirement benefits if, at all times, the aggregate of employer contributions to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions, other than contributions to fund past service credits.

The second requirement is that a separate account is to be maintained with respect to contributions to fund such medical benefits. This separate accounting generally is determined on an aggregate, rather than on a per-participant basis, and is solely for recordkeeping purposes. In addition, separate accounts are required to be maintained for each key employee in the same manner as under a welfare benefit fund.

The third requirement is that the employer's contributions to the separate account are to be reasonable and ascertainable. Fourth, the plan is required to preclude the use of amounts in the separate account for any other purposes at any time prior to the satisfaction of all liabilities with respect to the post-retirement medical benefits. Fifth, upon the satisfaction of all plan liabilities to provide post-retirement medical benefits, the remaining assets in the separate account are to revert to the employer and cannot be distributed to the retired employees.

If these requirements are satisfied, the income earned in the separate account (sec. 401(h) account) is not taxable. In addition, employer contributions to fund the benefits are deductible under the general rules relating to the timing of deductions for contributions to qualified pension plans. The deduction for such contributions are not taken into account in determining the amount deductible with respect to contributions for retirement benefits. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan and any other relevant considerations. In addition, the amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee, or (2) the amount necessary to amortize the unfunded costs over

a 10-year period. Certain contributions in excess of the deductible limit may be carried over and deducted in succeeding taxable years.

Legislative Background

The provision relating to the transfer of excess assets to retiree health accounts was added by the Omnibus Budget Reconciliation Act of 1990.

II. UTILIZATION OF SELECTED FEDERAL TAX PROVISIONS RELATED TO HEALTH CARE

A. Exclusion from Income and Wages for Employer-Provided Health Care

Table 14 shows the Federal tax expenditures for selected health care related tax provisions. By far the most significant provision, both in terms of the number of taxpayers that benefit and the cost to the Federal Government, is the exclusion from income and wages for employer-provided health care. The staff of the Joint Committee on Taxation estimates that the revenue loss from the exclusion from income is $57.9 billion in fiscal year 1999 (see Table 14). This estimate includes employer-provided health insurance obtained through cafeteria plans. This estimate does not include the effects of the exclusion for employment tax purposes.

A majority of the population now receives health insurance as a consequence of their own employment or of a family member's employment. In 1996, for 58 percent of the population, employment based health insurance was the primary source of health coverage, while 5 percent purchased insurance privately, 13 percent received Medicare benefits, 9 percent received Medicaid benefits, and 15 percent had no health insurance.[70]

Cafeteria plans are a growing part of compensation plans, particularly for large employers. Benefits provided through cafeteria plans are excluded from income to the extent such benefits are eligible for an exclusion based on other provisions of the Code. Thus, employer-provided health care benefits that are provided through cafeteria plans are eligible for an income exclusion. The Bureau of Labor Statistics estimates that in 1995, 55 percent of employees at large and medium sized firms were eligible for flexible benefits and/or reimbursement accounts. Smaller firms generally do not offer cafeteria plans. In 1994, only 19 percent of workers in small, private establishments (nonfarm establishments with fewer than 100 employees) were eligible to participate in a cafeteria plan.

B. Itemized Deduction for Medical Expenses and Long-Term Care Expenses

The staff of the Joint Committee on Taxation estimates that 4,701,000 tax returns had itemized deductions for medical expenses in 1998, resulting in a loss of Federal revenues of $3.7 billion in 1998.[71] The itemized deduction for medical expenses is intended to apply only to extraordinary medical expenses, and hence only medical expenses in excess of 7.5 percent of AGI can be deducted. The utilization of this provision thus depends on both the extent of a taxpayer's medical expenses in a given year, and on the taxpayer's AGI. Additionally, to the extent that AGI is low, taxpayers may find it more advantageous to claim the standard deduction rather than itemize deductions, even if their medical expenses exceeded 7.5 percent of their AGI.

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[70] Congressional Budget Office analysis of 1996 Current Population Survey.

[71] Figures do not include deductions for long-term care expenses.

The 7.5-percent floor for the medical expense deduction has a significant impact on the number of taxpayers who can claim the deduction. For example, when the medical deduction floor was increased from 3 percent of AGI to 5 percent of AGI, the number of tax returns claiming the deduction dropped from 22 million in 1982 to 9.7 million in 1983. Similarly, the increase from 5 percent of AGI to 7.5 percent saw a drop in the number of tax returns claiming the deduction from 10.5 million in 1986 to 5.4 million in 1987.[72] Table 15 shows the distribution by income class of the tax expenditure resulting from the deduction for medical expenses.

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependents are treated as medical expenses for purposes of the itemized deduction for medical expenses. Similarly, long-term care insurance premiums that do not exceed specified dollar limits are treated as medical expenses for purposes of the itemized deduction for medical expenses. The staff of the Joint Committee on Taxation estimates that the tax expenditure for the itemized deduction for medical expenses and long-term care expenses combined is $4.2 billion for fiscal year 1999 (see Table 14).

C. Deduction for Health Insurance and Long-Term Care Insurance Expenses of Self-Employed Individuals

The Federal tax revenues forgone by the deduction for health insurance premiums and long-term care insurance premiums by the self-employed is estimated by the staff of the Joint Committee on Taxation to be $800 million in fiscal year 1998 (see Table 14). Currently, the self-employed may deduct 45 percent of their premiums; this amount will gradually increase until it reaches 100 percent for 2007 and subsequent years. The rise in the deductible fraction implies a greater subsidy to self-employed health and long-term care insurance, and thus it is likely that the increased subsidy will induce more self-employed to purchase such insurance.

D. Medical Savings Accounts

As described previously, eligibility for contributions to MSAs is limited by a number of statutory provisions relating to the size of the employer and the nature of the health insurance offered by that employer. There is also an overall limit on the total number of MSAs that may be established. The utilization of MSAs has been well below the applicable numerical limit to date. The Internal Revenue Service ("IRS") determined that only 7,383 MSAs had been established as of April 30, 1997, 17,154 MSAs had been established as of June 30, 1997, and 44,523 had been established as of December 31, 1998. The tax expenditure cost of MSAs is estimated to be less than $50 million in each of the fiscal years 1999 through 2003 (see Table 14).

The General Accounting Office, ("GAO") was directed to contract with an organization with expertise in health economics, health insurance markets, and actuarial science to conduct a study regarding the effects of MSAs in the small group market on (1) selection (including

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[72] Internal Revenue Service figures.

adverse selection), (2) health costs, including the impact on premiums of individuals with comprehensive coverage, (3) use of preventive care, (4) consumer choice, (5) the scope of coverage of high deductible plans purchased in conjunction with an MSA and (6) other relevant issues, to be submitted to the Congress by January 1, 1999.

The GAO issued its final report an MSA experience in December 1998.[73] The GAO limited its study to a survey of insurers; because of the relatively low enrollment in MSAs, the GAO found it impossible to conduct useful surveys of enrollees, employers, or financial institutions at a reasonable cost. Key findings of the GAO study include the following:

- Consumer demand has been lower than many in the industry anticipated. Lower demand reflects, in part, the complexity of the qualifying plan/MSA product for both agents and consumers. Insurers and the Internal Revenue Service report that product sales have continued in the second year of the demonstration, but remain well below the HIPAA-imposed limits.

- The insurance industry responded to the legislation rapidly, with more than 50 companies offering qualifying products by the summer of 1997; between 1997 and 1998 the total number of companies offering qualifying products declined slightly.

- A wide range of insurers offer qualifying plans, and both traditional indemnity products and plans with managed care features (principally preferred provider organizations) are available.

- A minority of insurers offering qualifying plans are marketing them aggressively and remain optimistic that MSAs will be an important option in the market; other insurers are currently more passively in the market and have more of a "wait-and-see" view of MSAs.

- Insurers report that the supply of qualifying plans available and the enthusiasm with which they are marketed have been limited by features of the demonstration design.

- A majority of insurers sell qualifying plans bundled with the MSA; the accounts themselves are offering a wider variety of investment options and banking features as the demonstration matures.

- Qualifying plans have somewhat more generous benefits than other high deductible products offered by the same insurers; premiums for qualifying plans,

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[73] General Accounting Office, *Medical Savings Accounts, Results From Surveys of Insurers*, GAO/HEHS 99-31 (December 1988).

initially set very similarly to non-qualifying high deductible plans, have dropped in some cases between 1997 and 1998.

Table 14.–Tax Expenditure Estimates for Selected Health Care Provisions, Fiscal Years 1998-2002

[Billions of Dollars]

Provision	1999	2000	2001	2002	2003	Total 1999-2003
Exclusion of employer contributions for medical care, health insurance premiums, and long-term care insurance premiums[1]	57.9	61.3	65.1	69.2	73.8	327.3
Deduction for medical expenses and long-term care expenses	4.2	4.3	4.5	4.7	4.9	22.6
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	1.0	1.2	1.2	1.5	2.4	7.3
Medical savings accounts	(2)	(2)	(2)	(2)	(2)	0.1

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years, 1999-2003* (JCS-7-98), December 14, 1998. Tax expenditure estimates are for Federal income taxes only and do not include any effects on Social Security payroll taxes.

[1] Estimate includes employer-provided health insurance purchased through cafeteria plans.

[2] Less than $50 million.

Table 15.–Distribution By Income Class of Medical Deduction Tax Expenditure at 1998 Rates and 1998 Income Levels[1]

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

Income class[2]	Medical deduction[3]	
	Returns	Amount
Below $10,000	7	$ 2
$10,000 to $20,000	170	49
$20,000 to $30,000	556	172
$30,000 to $40,000	827	352
$40,000 to $50,000	794	406
$50,000 to $75,000	1,424	934
$75,000 to $100,000	578	683
$100,000 to $200,000	306	830
$200,000 and over	38	319
Total	4,701	$3,746

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1999-2003* (JCS-7-98), December 14, 1998. Tax expenditure estimates are for Federal income taxes only and do not include any effects on Social Security payroll taxes.

[1] Tax law as in effect on January 1, 1998. Excludes individuals who are dependents of other taxpayers.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

[3] Tax expenditures estimates does not include revenue losses attributable to deductions for long-term care and long-term care insurance premiums.

PART THREE: PRESENT LAW AND BACKGROUND RELATING TO ESTATE AND GIFT TAXES

I. PRESENT LAW AND LEGISLATIVE HISTORY

A. Present Law

Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[74] The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers[75] and reach 55 percent on cumulative taxable transfers over $3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between $10 million and the amount necessary to phase out the benefits of the graduated rates.[76]

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified graduated rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified graduated rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.

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[74] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

[75] The unified credit operates to effectively exempt from estate and gift tax the first $650,000 in cumulative taxable transfers in 1999. For transfers in excess of $650,000, estate and gift tax rates begin at 37 percent. The effective exemption is increased to $1 million in 2006 and thereafter.

[76] Thus, if a taxpayer has made cumulative taxable transfers in excess of the amount necessary to phase out the benefits of the graduated rates, his or her average transfer tax rate would approach but never reach 55 percent.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. From 1987 to 1997, the unified credit amount was $192,800, which effectively exempted a total of $600,000 in cumulative taxable transfers from the estate and gift tax. The Taxpayer Relief Act of 1997 ("1997 Act") increased the effective exemption to $625,000 in 1998, $650,000 in 1999, $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter.[77]

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year. For gifts made after 1998, the $10,000 exclusion will be increased annually for inflation occurring after 1997. This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Prior to 1982, the annual exclusion was $3,000.

Valuation

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. For Federal estate tax purposes, fair market value is determined at either (1) the time of the decedent's death, or (2) the "alternate" valuation date of six months after the decedent's death. For Federal gift tax purposes, fair market value generally is determined at the date of the gift.

Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its highest and best use value. Currently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000. For decedents dying after 1998, the $750,000 maximum reduction in value will be indexed annually for inflation occurring after 1997.

An estate may qualify for current-use valuation under section 2032A if: (1) the decedent was a citizen or resident of the United States at the time of death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of

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[77] P.L. 105-34 (August 5, 1997).

the adjusted value of the gross estate is qualified farm or closely held business real property[78]; (4) the real property qualifying for current-use valuation passes to a qualified heir[79]; (5) such real property was owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there was material participation in the operation of the farm or closely held business by the decedent or a member of the decedent's family in 5 years out of the 8 years immediately preceding the decedent's death. If, after an election is made to specially value property at its current-use value, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the estate-tax benefit of the current-use valuation.

Qualified family-owned business interests

An estate is permitted to deduct the adjusted value of the qualified "family-owned business interests" of the decedent, up to a total of $675,000. The deduction plus the unified credit exclusion amount may not exceed $1.3 million. (Code sec. 2057.)

A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if one family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in sec. 543). In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least 5 of the 8 years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) is required to actively participate in the trade or business for at least 10 years following the decedent's death.

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[78] For purposes of the 50-percent and 25-percent tests, the value of the property is determined without regard to its current-use value.

[79] The term "qualified heir" means a member of the decedent's family, which includes his or her spouse, lineal descendants, parents, aunts, uncles, and their descendants.

The benefit of the exclusion for qualified family-owned business interests is subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements; (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution; (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship.

The portion of the reduction in estate taxes that is recaptured depends upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business between the date of the decedent's death and the date of the recapture event. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than nine years, 40 percent is recaptured; and if the participation was for at least nine years but less than ten years, 20 percent of the reduction in estates taxes is recaptured. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under section 2032A(c)(7)(A), however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

Exclusion for land subject to permanent conservation easement

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter. (Code sec. 2031(c).) If the value of the conservation easement is less than 30 percent of the value of the land without the easement (reduced by the value of any retained development rights), then the exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land.

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For

purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

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

Generation-skipping transfer tax

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions.[80] The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million. Because both the generation-skipping transfer tax and the estate or gift tax can apply to the same transfer, the combined marginal tax rate on a generation-skipping transfer can reach nearly 80 percent.

Installment payment of estate tax

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first five years, followed by up to 10 annual installments of principal and interest. A special 2-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in taxable value of the closely-held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1,000,000 is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., 45 percent of the Federal short-term rate plus 3

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[80] A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a transfer from grandparent to grandchild). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

percentage points). Interest paid on estate taxes deferred under section 6166 is not deductible for estate or income tax purposes.

To qualify for the installment payment election, the decedent must have been a citizen or resident of the United States and the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate. In general, the installment payment election is available only if the estate directly owns an interest in a closely held active trade or business. Under a special rule, however, an executor may elect to look through certain non-publicly traded holding companies that own stock in a closely held active trade or business, but if the election is made, neither the five-year deferral (i.e., the provision that requires no principal payments until the fifth year) nor the special 2-percent rate applies.

If the installment payment election is made, a special estate tax lien applies to any property on which tax is deferred for the installment payment period.

State death tax[81] credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State (or the District of Columbia) with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, based on the size of the decedent's adjusted taxable estate. Most States impose a "pick-up" or "make-up" estate tax equal to the difference between the maximum State death tax credit and any inheritance or other succession taxes the State imposes. The effect of the "pick-up" tax is to ensure maximum revenues for the State without increasing the total tax burden on the estates of its residents.

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[81] The term "death taxes" is used to refer to taxes that are imposed at the time of the death of an individual. As used herein, the term includes taxes with other names. Such taxes include "inheritance taxes" and "estate taxes." An "inheritance tax" is a tax on the right to receive property at death from an individual and generally is measured by the amount that a particular legatee receives from the decedent. An "estate tax" is a tax on the right to transfer property at death and generally is measured by the total amount passing at the time of the decedent's death. Historically, inheritance taxes were imposed by States, while estate taxes were imposed by the Federal Government.

B. Legislative History

Federal death taxes before World War I

While States extensively used death taxes, Federal death taxes in this country, for most of its history, were imposed primarily to finance wars or threat of war. The first Federal death tax was imposed from 1797 until 1802 as a stamp tax on inventories of deceased persons, receipts of legacies, shares of personal estate, probates of wills, and letters of administration to pay for the development of strong naval forces felt necessary because of strained trade relations with France.[82] Subsequent to the repeal of the stamp tax,[83] there were no death taxes imposed by the Federal Government until the Civil War when the Federal Government imposed an inheritance tax between 1862 and 1870.[84] In order to finance the Spanish-American War, the Federal Government imposed its first estate tax in 1898, which remained in effect until its repeal in 1902.[85] While prior death taxes were primarily imposed to finance warfare, President Theodore Roosevelt proposed, in 1906, a progressive tax on all lifetime gifts and death time bequests to limit the amount that one individual could transfer to another, although no legislation immediately resulted from such proposal.[86]

Estate taxes from World War I through World War II

Estate taxes to finance World War I

The commencement of World War I caused revenues from tariffs to fall. The Federal Government in 1916[87] adopted a progressive estate tax on all property owned by the decedent at his or her death, certain lifetime transfers which were for inadequate consideration,[88] transfers not intended to take effect until death,[89] and transfers made in contemplation of death.

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[82] Act of July 6, 1797, 1 Stat. 527.

[83] Act of June 30, 1802, 2 Stat. 148.

[84] Act of July 1, 1862, 12 Stat. 432, 483; Act of July 15, 1870, 16 Stat. 256.

[85] War Revenue Act of 1898, 30 Stat. 448, 464 (July 4, 1898).

[86] See quotation in Paul, Randolph E., Taxation in the United States, p. 88 (Boston, 1954).

[87] Act of September 8, 1916, 39 Stat. 756.

[88] This rule is contained in section 2043 of present law.

[89] This rule is contained in section 2037 of present law.

The 1916 estate tax provided an exemption (in the form of a deduction) of $50,000 with rates from 1 percent on the first $50,000 of transferred assets to 10 percent on transferred assets in excess of $5 million. The next year, the revenue needs from the War resulted in increases in estate tax rates with a top rate of 25 percent on transfers in excess of $10 million.[90]

Estate and gift taxes between World Wars I and II

In the Revenue Act of 1918, estate tax rates on transfers under $1 million were reduced, but the tax was extended to life insurance proceeds in excess of $40,000 that were receivable by the estate or its executor and property subject to a general power of appointment.[91]

In 1924, the estate tax was changed by: (1) increasing the maximum rate to 40 percent; (2) broadening property subject to the tax to include jointly-owned property and property subject to a power retained by the decedent to alter, amend, or revoke the beneficial enjoyment of the property;[92] and (3) allowing a credit for State death taxes of up to 25 percent of the Federal tax. In addition, the first gift tax was imposed.

In 1926, the gift tax was repealed and estate tax rates were reduced to a maximum rate of 20 percent on transfers over $10 million. The exemption was increased from $50,000 to $100,000, and the credit for State death taxes was increased to 80 percent of the Federal tax.[93]

In 1932, with the advent of the Depression which reduced revenues from other sources and the need for revenues for new Government projects, estate tax rates were increased with a top rate of 45 percent on transfers over $10 million.[94] The tax was made applicable to lifetime transfers in which the transferor retained a life estate or the power to control who shall benefit from the property or income therefrom.[95] The exemption was reduced to $50,000, and the Federal gift tax was reimposed (at 75 percent of the estate tax rates) for cumulative lifetime gifts in excess of $5,000 per year.

Estate and gift tax rates were increased in 1934 to top rates of 60 percent and 45 percent, respectively, on transfers in excess of $10 million and again in 1935 to top rates of 70 percent

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[90] Act of March 3, 1917, 39 Stat. 1000.

[91] These rules are now contained in sections 2041 and 2514 of present law.

[92] This rule is now contained in section 2038 of present law.

[93] This rule is now contained in section 2011 of present law. The size of the credit has not changed even though the Federal estate tax rates subsequently have been changed several times.

[94] Revenue Act of 1932, 47 Stat. 169 (June 6, 1932).

[95] This rule is now contained in section 2036(a) of present law.

and 52.5 percent, respectively, on transfers in excess of $50 million.[96] The exemption for both the estate and gift tax was reduced in 1935 to $40,000 each.[97]

In 1940, a 10-percent surcharge was imposed on both income and estate and gift taxes, in light of the need for additional revenue necessitated by the military build-up just prior to World War II.[98] Estate and gift tax rates were increased in 1941, with a top estate tax rate of 77 percent on transfers in excess of $50 million.[99]

Estate and gift taxes during World War II

In 1942, Congress again altered estate and gift taxes by: (1) setting the exemption from the estate tax at $60,000, the lifetime exemption from the gift tax at $30,000, and providing an annual gift tax exclusion of $3,000;[100] and (2) attempting to equate property in community property States with property owned in non-community property States by providing that in both community property States and non-community States, each spouse would be taxed on the portion of jointly owned or community property that each spouse contributed to that property's acquisition cost.[101]

Estate and gift taxes after World War II

Post-World War II through 1975

The 1942 solution to the community property problem was viewed as complex. Congress provided a different solution in 1948 for equating community property States and non-community property States by providing the decedent or donor spouse a marital deduction for 50 percent of the property transferred to the other spouse and, thus, effectively allowing both spouses to be taxed on one-half of the property's value.[102]

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[96] Act of May 10, 1934, 48 Stat. 680.

[97] Act of August 30, 1935, 49 Stat. 1014.

[98] Revenue Act of 1940, 54 Stat. 516.

[99] Act of September 20, 1941, 55 Stat. 687.

[100] The $60,000 deathtime and the $30,000 lifetime exemptions remained at these levels until the Tax Reform Act of 1976 when the estate and gift taxes where combined into a single unified tax that could be reduced by a unified credit which replaces the two exemptions.

[101] Act of October 21, 1942, 56 Stat. 798.

[102] Revenue Act of 1948, 62 Stat. 110.

In 1954, the estate tax treatment of life insurance was changed to a rule that subjected life insurance proceeds to estate tax if the proceeds were paid to the decedent's estate or executor or if the decedent retained "incidents of ownership" in the life insurance policy.[103]

The Small Business Tax Revision Act of 1958[104] provided for payment of Federal estate tax on certain closely held businesses in installments over a 10-year period.[105]

Legislation from 1976 through 1980

In the Tax Reform Act of 1976,[106] Congress substantially revised estate and gift taxes by: (1) providing for a single unified rate structure for cumulative lifetime and deathtime transfers;[107] (2) providing an exemption in the form of a credit (called the "unified credit") which exempted $175,625 of transfers from tax when fully phased-in; (3) revising and lowering the unified rate structure such that the maximum rate of tax was 70 percent; (4) changing the income tax rules applicable to the disposition of inherited assets from a rule that only taxed post-death appreciation (i.e., the basis in the hands of the heir was "stepped-up" to its value on the date of the decedent's death) to one that provided that the heir's basis generally would be the same as its basis to the decedent (i.e., the decedent's basis in the property would "carryover" to be the basis to the heir); (5) providing a 100-percent marital deduction for the first $250,000 of property transferred to a surviving spouse; (6) changing the treatment of gifts made in contemplation of death from a rebuttable presumption that gifts made within three years of death would be subject to estate tax to a rule that subjects all gifts made within three years of death to the estate tax;[108] (7) providing that each spouse was rebuttably presumed to have contributed equally to the acquisition cost of jointly held property; (8) providing that a farm or other real property used in a closely held business could be valued at its "current use value" instead of its "highest and best use" value, so long as the heirs continued to so use the property for 15 years after the decedent's death;[109] (9) providing a limited deduction for bequests to children with no living parents (the so-called "orphan's deduction"); (10) providing a new transfer tax on generation-skipping transfers basically equal to the additional estate or gift tax that the decedent's children would

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[103] This rule is now contained in section 2042 of present law.

[104] P.L. 85-866 (September 2, 1958).

[105] This rule has been subsequently modified, and is now contained in section 6166 of present law.

[106] P.L. 94-455 (October 4, 1976).

[107] These rules are contained in sections 2001 and 2501 of present law.

[108] This rule is now contained in section 2035 of present law.

[109] These rules are now contained in section 2032A of present law.

have paid if the property had passed directly to the children instead in a form where the children received only an income interest or power to control the enjoyment of the property; (11) providing statutory rules governing the disclaimer of gifts and bequests under which an unqualified, irrevocable refusal to accept any benefits from the gift or bequest generally within 9 months of the creation of the transferee's interest is not treated as a gift by the disclaiming individual;[110] and liberalized the provision which permits installment payment of estate tax on closely-held business by providing that only interest need be paid for the first four years after death and lengthening the period of installment an additional four years to 14 years.

In 1980, the "carryover basis" rule was retroactively repealed and replaced by the "stepped-up basis" rules that applied before the 1976 legislation.[111]

Legislation from 1981 through 1985

The Economic Recovery Act of 1981 ("1981 Act")[112] made the following changes to the estate and gift taxes: (1) increased the unified credit such that, when fully phased-in in 1987, it effectively exempted the first $600,000 of transfers from the unified estate and gift tax; (2) reduced the top unified estate and gift tax rate from 70 percent to 50 percent over a four-year period (1982-1985); (3) provided for an unlimited deduction for transfers to spouses and permitted such a deduction (the so-called "QTIP deduction") even where the donee spouse could not control disposition of the property after that spouse's death, so long as that spouse had an income interest in that property and that property was subject to that spouse's estate and gift tax;[113] (4) increased the annual gift tax exemption from $3,000 per year per donee to $10,000 per year per donee; (5) changed the presumption that each spouse equally provided for the acquisition cost of jointly held property to an irrebuttable presumption; (6) modified the "current use" valuation rules by shortening to 10 years the period that heirs who inherit farms or other real property used in a closely held business were required to so use the property, and by increasing the maximum reduction in the value of such property from $500,000 to $750,000; (7) repealed the so-called "orphan's deduction;" (8) delayed the effective date of the generation-skipping transfer tax, (9) further liberalized and simplified the rules which permit the installment payment of estate tax on closely-held businesses.

The Deficit Reduction Act of 1984: (1) delayed for three years the scheduled reduction of the maximum estate and gift tax rates (such that maximum rate remained at 55 percent until 1988); (2) eliminated the exclusion for interests in qualified pension plans; (3) provided rules for

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[110] This rule is now contained in section 2518 of present law.

[111] Crude Oil Windfall Profits Act of 1980 (P.L. 96-223 (April 2, 1980)).

[112] P.L. 97-34 (August 13, 1981).

[113] This rule in now contained in section 2056 of present law.

the gift tax treatment of below-market rate loans; and (4) extended the rules which permit the installment payment of estate taxes on closely-held businesses to certain holding companies.

1986 and subsequent legislation

The Tax Reform Act of 1986[114] substantially revised the tax on generation-skipping transfers by applying a single rate equal to the highest estate tax rate (i.e., 55 percent) to all generation-skipping transfers in excess of $1 million and by broadening the definition of a generation-skipping transfer to include direct transfers from a grandparent to a grandchild (i.e., "direct skips").

The Omnibus Budget Reconciliation Act of 1987[115] made the following modifications: (1) provided special rules for so-called "estate freeze transactions" under which the person who engaged in such a transaction would be subject to estate tax on the value of such property; (2) provided a higher estate or gift tax rate on transfers in excess of $10 million in order to phase-out the benefits of the graduated rates under 55 percent and the unified credit; and (3) again delayed for five years the scheduled reduction in the estate and gift tax rates from 55 percent to 50 percent.

The Omnibus Budget Reconciliation Act of 1990 replaced the special rules for estate freeze transactions with a new set of rules that effectively subject to gift tax the full value of interests in property, unless retained interests in that property take certain specified forms.[116]

The maximum estate, gift, and generation-skipping transfer tax rate dropped to 50 percent after December 31, 1992, but the Omnibus Budget Reconciliation Act of 1993[117] restored the 55-percent top rate retroactively to January 1, 1993, and made that top rate permanent. The Taxpayer Relief Act of 1997[118] provided for gradual increases in the unified credit from $625,000 in 1998 to $1 million in 2006 and thereafter. A conforming amendment made to the 5-percent surtax continues to phase out the benefit of the graduated rates, but the benefit of the unified credit is no longer phased out. New exclusions for qualified family-owned businesses and for certain land subject to permanent conservation easements and a number of other changes were also enacted in 1997.

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[114] P.L. 99-514 (October 22, 1986). The rules added by the Tax Reform Act of 1986 are contained in sections 2601 - 2654 of present law.

[115] P.L. 100-203.

[116] These rules are contained in sections 2701- 2704 of present law.

[117] P.L. 103-66 (August 10, 1996).

[118] P.L. 105-34 (August 5, 1997).

Summary

Table 16 provides a summary of the annual gift tax exclusion, the exemption value of the unified credit, the threshold level of the highest statutory estate tax rate, and the highest statutory estate tax rate for selected years, 1977-1998.

Table 16.–Annual Gift Exclusion Amount, Exemption Value of Unified Credit for Taxable Transfers, Threshold Level of Highest Statutory Tax Rate, and Highest Statutory Tax Rate Applicable to Taxable Transfers, Selected Years, 1977-1998

Year	Annual gift exclusion single/joint (dollars)	Exemption value of unified credit (dollars)	Threshold of highest statutory tax rate (dollars)	Highest statutory tax rate (percent)
1977	3,000/6,000	120,667	5 million	70
1982	10,000/20,000	225,000	4 million	65
1983	10,000/20,000	275,000	3.5 million	60
1984	10,000/20,000	325,000	3 million	55
1985	10,000/20,000	400,000	3 million	55
1986	10,000/20,000	500,000	3 million	55
1987	10,000/20,000	600,000	3 million	55
1989	10,000/20,000	600,000	3 million	55[1]
1991	10,000/20,000	600,000	3 million	55[1]
1993	10,000/20,000	600,000	3 million	55[1]
1995	10,000/20,000	600,000	3 million	55[1]
1997	10,000/20,000	600,000	3 million	55[1]
1998	10,000/20,000	625,000	3 million	55[1]

Source: Joint Committee on Taxation.

Note: Since 1987, the benefits of the graduated rate structure and unified credit have been phased out at a 5-percent rate for estates between $10,000,000 and $21,040,000, creating an effective marginal tax rate of 60 percent for affected estates (with a $600,000 unified credit). The Taxpayer Relief Act of 1997[1] provided for gradual increases in the unified credit from $625,000 in 1998 to $1 million in 2006 and thereafter. A conforming amendment made to the 5-percent surtax continues to phase out the benefit of the graduated rates, but the benefit of the unified credit is no longer phased out. Thus, the 5-percent surtax applied to taxable estates between $10 million and $17,184,000.

II. BACKGROUND AND ANALYSIS RELATING TO ESTATE AND GIFT TAXATION

A. Background Data

Estates subject to the estate tax

Table 17 details the percentage of decedents subject to the estate tax for selected years since 1935. The percentage of decedents liable for the estate tax grew throughout the postwar era reaching a peak in the mid-1970s. The substantial revision to the estate tax in the mid-1970s[119] and subsequent further modifications in 1981 reduced the percentage of decedents liable for the estate tax to less than one percent in the late 1980s. Since that time, the percentage of decedents liable for the estate tax has gradually increased.

[119] See description of changes made to the estate tax in 1976 in Part I.B., above.

Table 17.-Number of Taxable Estate Tax Returns Filed as a Percentage of Deaths, Selected Years, 1935-1997

		Taxable estate tax returns filed[1]	
Year	Deaths	Number	Percent of deaths
1935	1,172,245	8,655	0.74
1940	1,237,186	12,907	1.04
1945	1,239,713	13,869	1.12
1950	1,304,343	17,411	1.33
1995	1,379,826	25,143	1.82
1961	1,548,665	45,439	2.93
1966	1,727,240	67,404[2]	3.90
1970	1,796,940	93,424[2]	5.20
1973	1,867,689	120,761[2]	6.47
1977	1,819,107	139,115[2]	7.65
1982	1,897,820	41,620[2,3]	2.19
1983	1,945,913	35,148[2,3]	1.81
1984	1,968,128	31,507[2,3]	1.60
1985	2,068,440	30,518[2,3]	1.46
1986	2,105,361	23,731	1.13
1987	2,123,323	21,335	1.00
1988	2,167,999	18,948	0.87
1989[4]	2,150,466	20,856	0.97
1990[4]	2,148,463	23,215	1.08
1991[4]	2,169,518	24,897	1.15
1992[4]	2,175,613	27,187	1.25
1993[4]	2,268,553	27,506	1.21
1994[4]	2,278,994	31,918	1.40
1995[4]	2,312,132	31,564	1.37
1996[4]	2,314,690	37,711	1.63
1997[4]	2,314,738	42,901	1.85

[1] Estate returns need not be filed in the year of the decedent's death.

[2] Not strictly comparable with pre-1966 data. For later years the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.

[3] Although the filing requirement was for gross estates in excess of $225,000 for 1982 deaths, $275,000 for 1983 deaths, and $325,000 for 1984 deaths, the data are limited to gross estates of $300,000 or more.

[4] Taxable estate data from 1989-1997 are from Internal Revenue Service, *Statistics of Income*.

Sources: Joseph A. Peachman, *Federal Tax Policy* (Washington Brookings Institutiion), 1987; Internal Revenue Service, *Statistics of Income*; and U.S. National Center for Health Statistics

The increasing percentage of decedents liable for estate tax in the period from 1940 through the mid-1970s and the similar increasing percentage since 1989 are the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth. The amount of wealth exempt from the Federal estate tax always has been expressed at a fixed nominal value. If the general price level in the economy rises from one year to the next and asset values rise to reflect this inflation, the "nominal" value of each individual's wealth will increase. With a fixed nominal exemption, annual increases in the price level will imply that more individuals will have a nominal wealth that exceeds the tax threshold. Alternatively stated, inflation diminishes the real, inflation-adjusted, value of wealth that is exempted by a nominal exemption. Thus, even if no one individual's real wealth increased, more individuals would be subject to the estate tax. This interaction between inflation and a fixed nominal exemption largely explains the pattern in Table 17.[120] The fixed nominal exemption was increased effective for 1977 and again between 1982 and 1987. Prior to 1977 and subsequent to 1987, the exemption was unchanged while the economy experienced general price inflation.

However, even if the exemption were modified annually to reflect general price inflation, one would still expect to see the percentage of decedents liable for estate tax rise because of the third factor, real growth. If the economy is experiencing real growth per capita, it must be

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[120] The 1988 percentage of decedents liable for estate tax of 0.87 may overstate the nadir achieved by the increase in the unified credit to an exemption equivalent amount of $600,000. This is because the 1981 legislation also increased the marital exemption to an unlimited exemption. (See Part I.B., above.) An increase in the marital exemption would be expected to reduce the percentage of decedents liable for the estate tax, both permanently and during a temporary period following the increase. The permanent effect results from some married couples having neither spouse liable for estate tax. The temporary reduction in the percentage of decedents liable for estate tax arises as follows. A married couple may have sufficient assets to be subject to the estate tax. During the transition period in which husbands and wives first take advantage of the unlimited marital exemption, the number of decedents liable for estate tax falls as the first spouse to die takes advantage of the expanded marital deduction, despite the fact that the surviving spouse subsequently dies with a taxable estate. In the long run, the number of new couples utilizing the unlimited marital deduction may be expected to approximately equal the number of surviving spouses becoming taxable after their decedent spouse had claimed the unlimited marital deduction.

accumulating capital.[121] Accumulated capital is the tax base of the estate tax. Thus, real growth can lead to more individuals having real wealth above any given fixed real exempt amount.[122]

Revenues from the estate, gift, and generation-skipping taxes

Table 18 provides summary statistics of the estate and gift tax for selected years. Total estate and gift receipts include taxes paid for estate, gift, and generation-skipping taxes as well as payments made as the result of IRS audits.

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[121] The following analysis assumes that the capital accumulated is physical or business intangible capital. Real per capita GNP could grow if individuals accumulated more knowledge and skills, or what economists call "human capital." Accumulation of human capital unaccompanied by the accumulation of physical or business intangible capital would not necessarily lead to increasing numbers of decedents becoming liable for estate tax.

[122] This analysis assumes that the capital accumulation is held broadly. If the growth in the capital stock were all due to a declining number of individuals doing the accumulating, then the distribution of wealth would be becoming less equal and real growth could be accompanied by a declining percentage of decedents being liable for estate tax.

Table 18.–Revenue from the Estate, Gift, and Generation-Skipping Transfer Taxes, Selected Years, 1940-1998

Year	Revenues ($ millions)	Percentage of total Federal receipts
1940	357	6.9
1945	638	1.4
1950	698	1.9
1955	924	1.4
1960	1,606	1.7
1965	2,716	2.3
1970	3,644	1.9
1975	4,611	1.7
1976	5,216	1.7
1977	7,327	2.1
1978	5,285	1.3
1979	5,411	1.2
1980	6,389	1.2
1981	6,787	1.1
1982	7,991	1.3
1983	6,053	1.0
1984	6,010	0.9
1985	6,422	0.9
1986	6,958	0.9
1987	7,493	0.9
1988	7,594	0.8
1989	8,745	0.9
1990	11,500	1.12
1991	11,138	1.06
1992	11,143	1.02
1993	12,577	1.09
1994	15,255	1.21
1995	15,087	1.12
1996	17,189	1.18
1997	19,845	1.26
1998	24,076	1.40

Sources: Joint Economic Committee, *The Federal Tax System: Facts and Problems*, 1964; Joseph A. Pechman, *Federal Tax Policy* (Washington: Brookings Institution), 1987; Internal Revenue Service, *Statistics of Income Bulletin*, Fall 1986, and U.S. Office of Management and Budget, *Budget of the United States Government Fiscal Year 2000*, and prior years.

Between 1993 and 1998, estate and gift receipts averaged double digit rates of growth. There are four possible reasons for the rapid growth in these receipts. First, because neither the amount of wealth exempt from the estate and gift tax or the tax rates were indexed, as explained above, an increasing number of persons became subject to estate and gift taxes. Second, the tremendous increase in value in the stock market over the past several years increased the value of estates that would have already been taxable, and increased the number of estates that became taxable. For example, the Dow Jones Industrial Average ended 1993 at approximately 3750, and ended 1998 at approximately 9,000. On average, one-third of the wealth in taxable estates consists of publicly traded stocks. Because the value of this component of wealth has more than doubled during the past five years, one would expect brisk growth in estate tax receipts from this alone. Third, while the overall population of the United States is growing at about a 1 percent annual rate, the number of persons aged 85 and older is growing at a rate of almost 3.5 percent annually. This also should increase the number of estate tax returns filed. Finally, the unlimited marital deduction included in the 1981 Act delayed the payment of estate tax, in most cases, until the surviving spouse died. On average, spouses survive their mates by about ten years. Therefore, during the decade of the 1990s, an increase in estate tax receipts is expected as the result of first-spouse deaths during the 1980s that used the unlimited marital deduction.

On the other hand, the 1997 Act included provisions that would be expected to reduce the number of estates subject to the estate tax. As explained in Part I, above, the 1997 Act enacted a schedule of increases in the unified credit which will culminate in the unified credit effectively exempting $1 million of a decedent's estate from tax beginning for decedents dying in 2006. Given most forecasts of inflation, this change increases the real (inflation adjusted) value of the $600,000 exemption that was available under the estate and gift tax between 1987 and 1997.[123] As explained above, increases in the real value of the unified credit generally would be expected to reduce the number of estates subject to tax. The 1997 Act also provided an additional exemption for certain qualified family-owned business interests and a partial exclusion from the estate tax of the value of land subject to certain qualifying estates, fewer estates would be expected to be subject to tax.

Table 19 shows the Joint Committee on Taxation staff present-law estimate of revenues from the estate, gift, and generation-skipping taxes for fiscal years 1999-2008. These estimates are based on the January 1999 baseline forecast for estate, gift, and generation-skipping taxes supplied by the Congressional Budget Office. Table 19 reports the Joint Committee on Taxation staff estimates of annual taxable estates and calculates the percentage of all deaths that taxable estates will represent.

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[123] If the inflation rate were to be 3 percent for each year between 1997 and 2006; the inflation-adjusted value of $600,000 in 2006 would be approximately $783,000.

Table 19.–Projections of Taxable Estates and Receipts from Estate, Gift, and Generation-Skipping Transfer Taxes, 1999-2008

Year	Exemption value of unified credit	Number of taxable estates	Percent of deaths	Receipts ($ billions)
1999	650,000	49,200	1.96	27.7
2000	675,000	51,700	2.03	28.8
2001	675,000	54,200	2.10	29.8
2002	700,000	57,000	2.17	30.8
2003	700,000	59,800	2.25	32.7
2004	850,000	62,800	2.33	33.8
2005	950,000	54,600	1.99	34.4
2006	1,000,000	50,400	1.82	35.7
2007	1,000,000	52,600	1.87	37.7
2008	1,000,000	56,200	1.97	39.7

Source: Joint Committee on Taxation staff estimates and calculations based on U.S. Census Bureau estimates of deaths in Jennifer Cheeseman Day, *Population Projects of the United States by Age, Sex, Race, and Hispanic Origin: 1995 to 2050*, U.S. Bureau of the Census, Current Population Reports, P25-1130, U.S. Government Printing Office, Washington, D.C. 1996.

B. Comparison of Transfer Taxation in the United States and Other Countries

Among developed countries, an inheritance tax is more common than the type of estate tax that is imposed in the United States. An inheritance tax generally is imposed upon the amount of wealth the transferee or donee receives rather than on the total wealth of the transferor. That is, the funds the heir receives in a bequest determines the tax imposed. The United States also imposes a generation-skipping tax in addition to any estate or gift tax liability on certain transfers to generations two or more younger than that of the transferee. This effectively raises the marginal tax rates on affected transfers. Countries that impose an inheritance tax do not have such a separate tax but may impose higher rates of inheritance tax on bequests that skip generations. Among developed countries, Australia and Canada impose neither an estate tax nor an inheritance tax.[124]

Because the U.S. estate and gift tax exempts transfers between spouses, provides an effective additional exemption of $650,000 (in 1999) through the unified credit, and exempts $10,000 of gifts per year per donee, the United States may have a larger exemption (a larger zero-rate tax bracket) than many other developed countries.[125] However, because most other countries have inheritance taxes, the total exemption depends upon the number and type of beneficiaries. While the effective exemption may be larger, with the exception of transfers to spouses, which are untaxed, marginal tax rates on taxable transfers in the United States generally are greater than those in other countries. This is particularly the case when comparing transfers to close relatives, who under many inheritance taxes face lower marginal tax rates than do other beneficiaries. On the other hand, the highest marginal tax may be applied at a greater level of wealth transfer than in other countries. It is often difficult to make comparisons between the U.S. estate tax and countries with inheritance taxes because the applicable marginal tax rate depends on the pattern of gifts and bequests.

It is difficult to assess the extent to which the practice of any of the foreign transfer taxes is comparable to the practice of transfer taxation in the United States. For example, in the United States, transfers of real estate generally are valued at their full and fair market value. In Japan, real estate is assessed at less than its fair market value. Land is assessed for inheritance tax

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[124] For a survey of the transfer tax systems of 28 countries see Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95), June 1, 1995, pp. C-1 through C-17. In Australia, the transferee receiving assets with accrued capital gains transferred at death retains the transferor's basis in the assets (carryover basis). In Canada, gains accrued on assets held by a taxpayer at the time of his or her death are treated as realized and taxable as income to the taxpayer. Assets transferred to a spouse are untaxed but retain the decedent spouse's basis (carryover basis).

[125] Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation.*

purposes according to a valuation map known as *Rosen Ka*. The *Rosen Ka* values range from 25 to 80 percent of fair market value.[126] It is also unclear to what extent transferors may be able to exploit legal loopholes under the various systems imposed by other countries. Again, using Japan as an example, prior to 1988, a transferor could reduce inheritance tax liability by adopting children to increase the number of legal heirs.[127] Such adoptees of convenience would receive nominal compensation for agreeing to be an adoptive child. The larger the number of children, the greater the total exemption for inheritance taxes in Japan, even if not all children receive a bequest. This legal loophole was said to be widely recognized and exploited by wealthy families.[128]

Table 20 compares total revenue collected by OECD countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product (GDP) to attempt to compare the economic significance of wealth transfer taxes in different countries. Among these selected OECD countries, Belgium, France, Greece, and Japan collect more such revenue as a percentage of GDP than does the United States. Switzerland and the Netherlands collect modestly less revenue from such taxes as a percentage of GDP than does the United States. The remaining 17 countries in Table 20 collect substantially less revenue from such taxes as a percentage of GDP than does the United States. As a percentage of tax revenue, only Japan relies more heavily on its inheritance tax as a revenue source, although Belgium, France, and Switzerland each collected 0.8 of one percent of total tax revenue from estate, inheritance, and gift taxes.

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[126] Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Kreuger (eds.), *The Political Economy of Tax Reform* (Chicago: The University of Chicago Press), 1992, pp. 250-251.

[127] Adoption by another did not cause an adoptee to lose his or her legal right to be an heir of his or her biological parents.

[128] Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," p. 249.

Table 20.–Revenue from Estate, Inheritance and Gift Taxes as a Percentage of Total Tax Revenue and GDP in OECD Countries, 1996

Country	Percentage of total tax revenue	Percentage of GDP
Australia	0.00	0.00
Austria	0.12	0.05
Belgium	0.81	0.37
Canada	0.00	0.00
Denmark	0.43	0.23
Finland	0.47	0.23
France	0.88	0.40
Germany	0.30	0.11
Greece	1.88	0.36
Iceland	0.29	0.09
Ireland	0.55	0.19
Italy	0.17	0.07
Japan	1.70	0.48
Luxembourg	0.28	0.12
Netherlands	0.68	0.29
New Zealand	0.01	0.00
Norway	0.25	0.10
Portugal	0.21	0.07
Spain	0.52	0.18
Sweden	0.16	0.08
Switzerland	0.87	0.30
Turkey	0.06	0.01
United Kingdom	0.62	0.22
United States	1.06	0.30

Note: Data not directly comparable to data reported in Table 18. The OECD attempts to collect standardized data across member countries. OECD data includes tax revenue collected by the States as well as the Federal Government. Therefore data in OECD reports for the United States may not perfectly correspond to data as reported by OMB.

Source: Organization for Economic Cooperation and Development, *Revenue Statistics, 1965-1997* (Paris: OCED), 1998.

The United States is a wealthy country, with higher average household wealth than most of the countries surveyed. While exemption levels are higher in the United States than most other countries, a significant amount of accumulated wealth still may be subject to estate and gift taxation as compared to the other countries. The data in Table 20 do not reveal the extent to which estate, inheritance, and gift taxes fall across different individuals within each country. In the United States, as reported in Table 17, above, of the 2.3 million deaths in 1997, only 42,901 or 1.85 percent of decedents, gave rise to any estate tax liability. Similar data were not available for the other countries in this survey.

C. Economic Issues Related to Transfer Taxation

Taxes on income versus taxes on wealth

Income taxes, payroll taxes, and excise and other consumption taxes generally tax economic activity as it occurs. Income and consumption represent ongoing, current economic activity by the taxpayer.[129] Accumulated wealth, on the other hand, does not correspond to any ongoing, current economic activity.[130] Wealth depends upon previous economic activity either by the current wealth holder or other individuals. For example, current wealth can result from accumulated saving from income or from bequests received.

Taxes on wealth are not directly comparable to taxes on income. Because wealth is the accumulation of flows of saving over a period of years, taxes on wealth are not directly comparable to taxes on income or consumption which may represent only current, rather than accumulated, economic activity. For example, assume that a taxpayer receives wage income of $10,000 per year, saves all of this income, and the savings earn an annual return of 5 percent. At the end of five years, the accumulated value of the taxpayer's investments would be $58,019. Assume that the wealth is transferred at the end of the fifth year. If a 10-percent tax were imposed on wage income, one would conclude that a burden of $1,000 was imposed annually. If a 10-percent tax were imposed on the transfer of wealth, one would conclude that a burden of $5,801.90 was imposed at the end of the fifth year. If, after paying the wage tax, the taxpayer had invested the remaining $9,000 each year to earn 5 percent, the taxpayer's holding would be $52,217.10 at the end of five years. This is the same value that would remain under the wealth tax ($58,019.00 less $5,801.90). Thus, it is misleading to say that the burden of the wage tax is $1,000 in each year while the burden of the transfer tax is $5,801.90 in the fifth year.

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[129] Economists call income and consumption "flow" concepts. In simple terms, a flow can only be measured by reference to a unit of time. Thus, one refers to a taxpayer's annual income or monthly consumption expenditures.

[130] Economists call wealth a "stock" concept. A stock of wealth, such as a bank account, may generate a flow of income, such as annual interest income.

Wealth taxes, saving, and investment

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no economic consensus on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (decreases) in the after-tax return to investments by decreasing (increasing) their saving. Again there is no census in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.[131]

Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs. It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.[132] Others question the importance of the bequest motive in national capital formation.[133] Nor has direct empirical analysis of the existence of a bequest motive led to

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[131] For a more detailed discussion of the incidence of taxes on the income from capital and the responsiveness of saving to after-tax rate of returns, see Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-46.

[132] See, Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, 89, August, 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, 2, Spring, 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, 45, June, 1992. For recent attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Barthold and Ito, "Bequest Taxes and Accumulation of Household Wealth," and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

[133] Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *The Journal of Economic Perspectives*, 2, Spring, 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

a consensus.[134] Theoretically, it is an open question whether estate and gift taxes encourage or discourage saving and there has been no empirical analysis of this specific issue. By raising the cost, in terms of taxes, of leaving a bequest, potential transferors may be discouraged from accumulating the assets necessary to make a bequest. On the other hand, some individuals purchase additional life insurance in order to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Regardless of any potential effect on aggregate saving, the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. They note that if a family has a substantial proportion of its wealth invested in one enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained. There is some evidence that many businesses may be constrained by the capital markets in the amount of funds they can borrow. If they are so constrained, they may reduce the amount of investment they undertake, to the detriment of the economy at large.[135] Undercapitalization may be prevalent among small businesses. A recent study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[136]

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[134] See, B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," *American Economic Review*, 77, June 1987, pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings.... Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities." (p. 308).

[135] Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," *Brookings Papers on Economic Activity*, 1988, pp. 141-195.

[136] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102, February 1994, pp. 53-75. Holtz-Eakin, Joulfaian, and Rosen study the effect of receipt of an inheritance on whether an entrepreneur's business survives rather than whether an on-going business taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a $150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises

Others argue that potential deleterious effects on investment by small or family-owned businesses are limited. As a result of the Taxpayer Relief Act of 1997, certain small businesses can obtain an effective exemption of up to $2.6 million per married couple, and other legitimate tax planning can further reduce the burden on such enterprises. Some have argued that estate tax returns report a small fraction of the value of decedents' estates.[137]

Wealth taxes and labor supply

As people become wealthier, they generally choose to consume more leisure time. Some, therefore, suggest that, by reducing the potential wealth of heirs, transfer taxes may have an effect on labor supply. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would...."[138] While in theory increases in wealth should reduce labor supply, empirically economists have not found strong support for this proposition.[139]

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do survive, inheritances have a substantial impact on their performance: the $150,000 inheritance ... is associated with a nearly 20-percent increase in an enterprise's receipts" (p.74).

These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received.

[137] See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance*, (Washington, D.C.: The Brookings Institution), 1979. Also, see B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, 1, (Cambridge, Mass.: The MIT Press), 1987; and Alicia H. Munnell with Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, November/December 1988. These studies pre-date the enactment of chapter 14 of the Internal Revenue Code. The purpose of chapter 14 is to improve reporting of asset values in certain transfers.

[138] Andrew Carnegie, "The Advantages of Poverty," in *The Gospel of Wealth and Other Timely Essays*, Edward C. Kirkland (ed.), (Cambridge, MA: The Belknap Press of Harvard University Press), 1962, reprint of Carnegie from 1891.

[139] For a review of this issue, see John Pencavel, "Labor Supply of Men: A Survey," in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. I, (New York, NY: North-Holland Publishing Co.) 1986. For a direct empirical test of what some refer to as the "Carnegie Conjecture," see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "The Carnegie Conjecture: Some Empirical Evidence," *Quarterly Journal of Economics*, 108, May 1993, pp. 413-435. Holtz-Eakin, Joulfaian, and Rosen assess the labor force participation of families that receive an inheritance. They find that "the likelihood that a person decreases his or

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, the transfer taxes may help prevent an increase in the distribution of wealth. There are relatively few analyses of the distribution of wealth holdings.[140] Conventional economic wisdom holds that the Great Depression of the 1930s and the second world war substantially reduced the concentration of wealth in the United States, and that there has been no substantial change in the succeeding decades. Most analysts assign no role to tax policy in the reduction in wealth concentration which occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since the second world war.[141]

Others note that the income tax does not tax all sources of income. They suggest that by serving as a "backstop" for income that escapes income taxation, the transfer taxes may help promote overall fairness of the U.S. tax system. Others counter that to the extent that much wealth was accumulated with after-(income)-tax dollars, as an across-the-board tax on wealth, transfer taxes tax more than just those monies that may have escaped the income tax. In addition, depending upon the incidence of such taxes, it is difficult to make an assessment regarding the transfer taxes' contribution to the overall fairness of the U.S. tax system.

Even if transfer taxes are believed to be borne by the owners of the assets, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A tax is assessed on the transferor for taxable gifts. Assume, for example, a mother makes a gift of $1

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her participation in the labor force increases with the size of the inheritance received. For example, families with one or two earners who received inheritances above $150,000 [in 1982-1985 constant dollars] were about three times more likely to reduce their labor force participation to zero than families with inheritances below $25,000. Moreover, ... high inheritance families experienced lower earnings growth than low inheritance families, which is consistent with the notion that inheritance reduces hours of work" (pp. 432-433).

[140] For some exceptions, see Martin H. David and Paul L. Menchik, "Changes in Cohort Wealth Over a Generation," *Demography*, 25, August 1988; Paul L. Menchik and Martin H. David, "The Effect of Income Distribution on Lifetime Savings and Bequests," *American Economic Review*, 73, September 1983; and Edward N. Wolff, "Estimate of Household Wealth Inequality in the U.S., 1962-1983," *The Review of Income and Wealth*, 33, September 1987.

[141] See Michael K. Taussig, "Les inegalites de patrimoine aux Etats-Unis," in Kessler, Masson, Strauss-Khan (eds.) *Accumulation et Repartition des Patrimoines*. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolf, in "Estimate of Household Wealth Inequality in the U.S., 1962-1983," does not attribute any movements in wealth contribution directly to tax policy, but rather to the changes in the relative values of housing and corporate stock.

million to her son and incurs a gift tax liability of $500,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by $500,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $1.5 million, so that the gift tax has reduced the son's economic well-being by $500,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and donee generations may not be important to assessing the fairness of transfer taxes if both the donor and donee have approximately the same income.[142]

Federal estate taxation and charitable bequests

The two unlimited exclusions under the Federal estate tax are for bequests to a surviving spouse and for bequests to a charity. Because the marginal tax rates under the estate tax range from 37 percent to 55 percent, while marginal income tax rates range from 15 to 39.6 percent, the after-tax cost of a charitable bequest is lower than the after-tax cost of a charitable gift made during one's lifetime.[143] Some analysts have suggested that the charitable exclusion creates a strong incentive to make charitable bequests and that changes in Federal estate taxation could alter the amount of funds that flow to charitable purposes. A limited number of studies have examined the effects of estate taxes on charitable bequests. Most of these studies have concluded that, after controlling for the size of the estate and other factors, deductibility of charitable

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[142] Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," *American Economic Review*, 82, June 1992, and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," *American Economic Review*, 82, June 1992.

[143] Economists note that when expenditures on specified items are permitted to be deducted from the tax base, before the computation of tax liability, the price of the deductible item is effectively reduced by a percentage equal to the taxpayer's marginal tax rate. Assume, for example, a decedent has a $1 million taxable estate and that the marginal, and average, estate tax rate were 40 percent. This means that the estate tax liability would be $400,000. A net of $600,000 would be available for distribution to heirs. If, however, the decedent had provided that his estate make a charitable bequest of $100,000, the taxable estate would equal $900,000 and the estate tax liability would be $360,000. By bequeathing $100,000 to charity, the estate's tax liability fell by $40,000. The net available for distribution to heirs after payment of the estate tax and payment of the charitable bequest would be $540,000. The $100,000 charitable bequest only reduced the amount of funds available to be distributed to heirs by $60,000. Economists say that the $100,000 charitable bequest "cost" $60,000, or that the "price" of the bequest was 60 cents per dollar of bequest. More generally, the "price" of charitable bequest equals $(1 - t)$, where t is the estate's marginal tax rate.

bequests encourages taxpayers to provide charitable bequests.[144] Some analysts interpret these findings as implying that reductions in estate taxation could lead to a reduction in funds flowing into the charitable sector. This is not necessarily the case, however. Some charitable bequests may substitute for lifetime giving to charity, in part to take advantage of the greater value of the charitable deduction under the estate tax than under the income tax that results from the lower marginal income tax rates and limitations on annual lifetime giving. If this is the case, reductions in the estate tax could lead to increased charitable giving during the taxpayer's life.

Federal estate taxes and State revenues

As explained in Part I, above, the State death tax credit acts as a revenue sharing provision with States that impose "pick-up" or "make-up" estate taxes. The State death tax credit effectively cedes revenue to those States that impose such taxes without increasing the aggregate tax burden imposed upon an estate. Repeal of the Federal estate tax would eliminate this source of revenue sharing. The burden of estate taxation would rest with the States.

All States and the District of Columbia impose estate, gift, or inheritance taxes. Most States impose only "pick-up" estate taxes. A few States also impose additional estate or inheritance taxes. In those States that impose only a "pick-up" estate tax, such taxes currently impose no incremental burden on the estate. With the repeal of the Federal estate tax, these taxes would now impose a burden on estates. This may create sentiment to repeal these State level taxes, but repeal of the State level taxes may require States to increase other taxes to make up for the loss of the implicit revenue sharing provided under present law.

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[144] For example, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; David Joulfaian, "Charitable Bequests and Estate Taxes, *National Tax Journal*, 44, June 1991, pp. 169-180; and Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics*, 59 January 1996, pp. 55-68. Each of these studies estimates a tax price elasticity in excess of 1.6 in absolute value. This implies that for each 10-percent reduction in the tax price, where the tax price is defined as one minus the marginal tax rate, there is a greater than 16-percent increase in the dollar value of charitable bequests. Such a finding implies that charities receive a greater dollar value of bequests than the Treasury loses in forgone tax revenue.

Not all studies find such responsiveness of charitable bequests to the marginal estate tax rate. Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," *National Tax Journal*, 37, June 1984, pp. 225-237, estimated that marginal tax rates had no effect on charitable bequests.