[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are contained in the President's fiscal year 2006 budget proposal, as submitted to the Congress on February 7, 2005.[2] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget proposal.[3] For each provision, there is a description of present law and the proposal (including effective date), an analysis of policy issues related to the proposal, and a reference to relevant prior budget proposals or recent legislative action.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal* (JCS-3-05), March 2005.

[2] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006: Analytical Perspectives* (H. Doc. 109-2, Vol. III), at 263-300.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals*, February 2005.

I. MAKING PERMANENT TAX CUTS ENACTED IN 2001 AND 2003

A. Permanently Extend Certain Provisions Expiring Under EGTRRA and JGTRRA

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the Federal tax laws, including reducing individual tax rates, repealing the estate tax, increasing and expanding various child-related credits, providing tax relief to married couples, providing additional education-related tax incentives, increasing and expanding various pension and retirement-saving incentives, and providing individuals relief relating to the alternative minimum tax. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974, EGTRRA included a "sunset" provision, pursuant to which the provisions of the Act expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010.

EGTRRA provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though EGTRRA had never been enacted. For example, the estate tax, which EGTRRA repeals for decedents dying in 2010, will return as to decedents dying after 2010, in pre-EGTRRA form, without the various interim changes made by the Act (e.g., the rate reductions and exemption equivalent amount increases applicable to decedents dying before 2010). Similarly, the top individual marginal income tax rate, which EGTRRA reduced to 35 percent will return to its pre-EGTRRA level of 39.6 percent in 2011 under present law. Likewise beginning in 2011, all other provisions of the Code and ERISA will be applied as though the relevant provisions of EGTRRA had never been enacted.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA")

In general

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") changed the expensing of certain depreciable business assets, individual capital gains tax rates and the tax rates on dividends received by individuals. The expensing provision sunsets for taxable years beginning after December 31, 2007. The capital gains and dividend provisions sunset for taxable years beginning after December 31, 2008.

Expensing provisions

JGTRRA provides that the maximum dollar amount that may be deducted as an expense under section 179 is increased to $100,000 (and indexed for inflation) for property placed in

service in taxable years beginning before 2008.[4] In addition, for purposes of the phase-out of the deductible amount, the pre-JGTRRA $200,000 amount at which the phase-out begins is increased to $400,000 (and indexed for inflation) for property placed in service in taxable years beginning before 2008. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning before 2008 as qualifying property. With respect to taxable years beginning before 2008, the provision permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner.

Individual capital gains rates

Under JGTRRA, for taxable years beginning before January 1, 2009, generally the maximum rate of tax on net capital gain of a non-corporate taxpayer is 15 percent. In addition, any net capital gain which otherwise would have been taxed at a 10- or 15-percent rate generally is taxed at a five-percent rate (zero for taxable years beginning after 2007). For taxable years beginning after December 31, 2008, generally the rates on net capital gain are 20 percent and 10 percent, respectively. Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10 percent rate is taxed at an eight percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise be taxed at a 20 percent rate is taxed at an 18-percent rate.

Taxation of dividends received by individuals

Under JGTRRA, dividends received by a non-corporate shareholder from domestic corporations and qualified foreign corporations generally are taxed at the same rates that apply to net capital gain. Thus, dividends received by an individual, estate, or trust are taxed at rates of five (zero for taxable years beginning after 2007) and 15 percent. This treatment applies to taxable years beginning before January 1, 2009.

For taxable years beginning after December 31, 2008, dividends received by a non-corporate shareholder are taxed at the same rates as ordinary income.

Description of Proposal

The proposal repeals the sunset provisions of EGTRRA and JGTRRA.

Specifically, the proposal permanently extends all provisions of EGTRRA that expire at the end of 2010. Thus, the estate tax remains repealed after 2010, and the individual rate reductions and other provisions of the Act that are in effect in 2010 will remain in place after 2010.[5]

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[4] Present law is described as amended by the American Jobs Creation Act of 2004.

[5] However, certain provisions expire separately under the Act before the end of 2010. For example, the increased AMT exemption amounts expire after 2005, and thus is unaffected by the proposal.

Also, the proposal permanently extends the provisions of JGTRRA relating to expensing, capital gains, and dividends.

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

Analysis

In general

The policy merits of permanently extending the provisions of EGTRRA and JGTRRA that sunset depend on considerations specific to each provision. In general, however, advocates of eliminating the sunset provisions may argue that it was never anticipated that the sunset actually would be allowed to take effect, and that eliminating them promptly would promote stability and rationality in the tax law. In this view, if the sunsets were eliminated, other rules of EGTRRA and JGTRRA that phase in or phase out provisions over the immediately preceding years would be made more rational. On the other hand, others may argue that certain provisions of EGTRRA and JGTRRA would not have been enacted at all, or would not have been phased in or phased out in the same manner, if the sunset provisions had not been included in EGTRRA and JGTRRA, respectively.

Complexity issues

The present-law sunset provisions of EGTRRA and JGTRRA arguably contribute to complexity by requiring taxpayers to contend with (at least) two different possible states of the law in planning their affairs. For example, under the sunset provision of EGTRRA, an individual planning his or her estate will face very different tax regimes depending on whether the individual dies in 2010 (estate tax repealed) or 2011 (estate tax not repealed). This "cliff effect" requires taxpayers to plan an estate in such a way as to be prepared for both contingencies, thereby creating a great deal of complexity. On the other hand, some may argue that this kind of uncertainty is always present to some degree – with or without a sunset provision, taxpayers always face some risk that the Congress will change a provision of law relevant to the planning of their affairs. Others may acknowledge this fact, but nevertheless argue that the sunset provision creates an unusual degree of uncertainty and complexity as to the areas covered by the Act, because they consider it unlikely that the sunset will actually go into effect. In this view, the sunset provision of EGTRRA leaves taxpayers with less guidance as to the future state of the law than is usually available, making it difficult to arrange their affairs. In addition to the complexity created by the need to plan for the sunset, uncertainty about the timing and details of how the sunset might be eliminated arguably creates further complexity.

Even if it is assumed that the sunset provisions will take effect, it is not clear how the sunsets would apply to certain provisions. It would be relatively simple to apply the EGTRRA sunset to some provisions, such as the individual rate reductions. With respect to other provisions, however, further guidance would be needed as to the effect of the sunset. For example, if the Code will be applied after 2010 as if the Act had never been enacted, then one possible interpretation of the pension provisions is that contributions made while EGTRRA was in effect will no longer be valid, possibly resulting in the disqualification of plans. While this

result was likely not intended, without further guidance taxpayers may be unsure as to the effect of the sunset.

More broadly, in weighing the overall complexity effects of the present-law sunsets and the proposed sunset repeal, some would point out that the sunset provisions are not the only feature of EGTRRA and JGTRRA that generates "cliff effects" and similar sources of uncertainty and complexity for taxpayers. For example, under EGTRRA's estate tax provisions, a decedent dying in 2008 has an exemption equivalent amount of $2 million, one dying in 2009 has an exemption equivalent amount of $3.5 million, and one dying in 2010 effectively has an infinite exemption but not a complete "step-up" in the basis of assets. Thus, the estates of individuals at certain wealth levels will incur significant estate tax if they die in 2008, but none at all if they die in 2009; the estates of individuals at other wealth levels will incur significant estate tax if they die in 2009, but none at all if they die in 2010. These discontinuities are not caused by the sunset provisions, but they generate a similar sort of uncertainty and complexity for many taxpayers. Similar phase-ins and phase-outs are found in other provisions of EGTRRA and generate complexity and uncertainty, irrespective of whether EGTRRA as a whole sunsets or not. In light of these issues, some may argue that a more detailed reconsideration of EGTRRA or certain of its provisions would better serve the goal of tax simplification.

Beyond phase-ins and phase-outs, some may argue that EGTRRA included other provisions that increased the complexity of the Code, and that allowing those provisions to expire at the end of 2010 (or effectively requiring that they be reconsidered before then) may reduce complexity, albeit potentially years in the future. Others would argue that some of EGTRRA's provisions reduced complexity, such as the repeal of the overall limitation on itemized deductions and changes relating to the earned income tax credit, and that permanently extending these provisions would contribute to simplification of the tax laws.

Prior Action

A similar proposal was included in the President's fiscal year 2003, 2004, and 2005 budget proposals.

II. TAX INCENTIVES

A. Provisions Related to Savings

1. Expansion of tax-free savings opportunities

Present Law

In general

Present law provides for a number of vehicles that permit individuals to save on a tax-favored basis. These savings vehicles have a variety of purposes, including encouraging saving for retirement, encouraging saving for particular purposes such as education or health care, and encouraging saving generally.

The present-law provisions include individual retirement arrangements, qualified retirement plans and similar employer-sponsored arrangements, Coverdell education savings accounts, qualified tuition programs, health savings accounts, Archer medical savings accounts, annuity contracts, and life insurance. Certain of these arrangements are discussed in more detail below.

Individual retirement arrangements ("IRAs")

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[6] to which both deductible and nondeductible contributions may be made,[7] and Roth IRAs.[8] The Federal income tax rules regarding each type of IRA (and IRA contributions) differ.

The maximum annual deductible and nondeductible contributions that can be made to a traditional IRA and the maximum contribution that can be made to a Roth IRA by or on behalf of an individual varies depending on the particular circumstances, including the individual's income. However, the contribution limits for IRAs are coordinated so that the maximum annual contribution that can be made to all of an individual's IRAs is the lesser of a certain dollar amount ($4,000 for 2005)[9] or the individual's compensation. In the case of a married couple,

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[6] Sec. 408.

[7] Sec. 219.

[8] Sec. 408A.

[9] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the dollar limit on IRA contributions to $4,000 for 2005 through 2007, and $5,000 for 2008. After 2008, the limit is adjusted for inflation in $500 increments. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010. Thus, the dollar

contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. As a result, the maximum deduction for IRA contributions for an individual who has attained age 50 is increased by a certain dollar amount ($500 for 2005).[10] Under present law, IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Table 1.–AGI Phase-Out Range for Deductible IRA Contributions

Single Taxpayers	
Taxable years beginning in:	*Phase-out range*
2005 and thereafter	50,000-60,000
Joint Returns	
Taxable years beginning in:	*Phase-out range*
2005	70,000-80,000
2006	75,000-85,000
2007 and thereafter	80,000-100,000

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

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

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limit on annual IRA contributions returns to $2,000 in 2011. A proposal to make the EGTRRA provisions that expire on December 31, 2010, permanent is discussed in Part I of this document.

[10] Under EGTRRA, the additional amount permitted for catch-up contributions to an IRA is $500 for 2005 and $1,000 for 2006 and thereafter. As a result of the general sunset provision of EGTRRA, catch-ups contributions are not permitted after 2010.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions. An individual who has attained age 50 before the end of the taxable year may also make nondeductible catch-up contributions to an IRA.

An individual who has attained age 70-½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Early withdrawals from an IRA generally are subject to an additional 10-percent tax.[11] That is, includible amounts withdrawn prior to attainment of age 59-½ are subject to an additional 10-percent 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 adjusted gross income, is used to purchase health insurance of certain unemployed individuals, is used for higher education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Distributions from traditional IRAs generally are required to begin by the April 1 of the year following the year in which the IRA owner attains age 70-½. If an IRA owner dies after minimum required distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the IRA owner dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the IRA owner's death. The five-year rule does not apply if distributions begin within one year of the IRA owner's death and are payable over the life or life expectancy of a designated beneficiary. Special rules apply if the beneficiary of the IRA is the surviving spouse.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of a certain dollar amount ($4,000 for 2005) or the individual's compensation for the year. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a Roth IRA up to a certain dollar amount ($500 for 2005).

The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with adjusted gross income between $95,000 and $110,000 and for joint filers with adjusted gross income between $150,000 and $160,000. The adjusted gross income phase-out range for

[11] Sec. 72(t).

married taxpayers filing a separate return is $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

Taxpayers with modified adjusted gross income of $100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, 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. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions; (2) conversion contributions (on a first-in, first-out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. The amount includible in income is also subject to the 10-percent early withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs.

Saver's credit

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[12] The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Taxpayers filing joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return. The credit is available with respect to contributions to

[12] Sec. 25B. The Saver's credit does not apply to taxable year's beginning after January 31, 2006.

various types of retirement savings arrangements, including contributions to a traditional or Roth IRA.

Coverdell education savings accounts

Present law provides tax-exempt status to Coverdell education savings accounts, meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary.[13] The aggregate annual contributions that can be made by all contributors to Coverdell education savings accounts for the same beneficiary is $2,000 per year. In the case of contributors who are individuals, the maximum contribution limit is reduced for individuals with adjusted gross income between $95,000 and $110,000 ($190,000 to $220,000 in the case of married taxpayers filing a joint return).[14] Contributions to a Coverdell education savings account are not deductible.

Distributions from a Coverdell education savings account are not includible in the distributee's income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a Coverdell education savings account exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a Coverdell education savings account may be rolled over on a tax-free basis to another Coverdell education savings account of the same beneficiary or of a member of the family of that beneficiary.

Qualified tuition programs[15]

Present law provides tax-exempt status to a qualified tuition program, defined as a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions.[16] Under a qualified tuition program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary, or in the case of a

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[13] Sec. 530.

[14] The present-law contribution limit and the adjusted gross income levels are subject to the general sunset provision of EGTRRA. Thus, for example, the limit on annual contributions to a Coverdell education savings account is $500 after 2010.

[15] A proposal relating to qualified tuition programs is discussed in Part V.G. of this document.

[16] Sec. 529. The general sunset provision of EGTRRA applies to certain aspects of the rules for qualified tuition programs, including tuition programs maintained by one or more eligible educational institutions (which may be private institutions). Thus, for example, after 2010 a qualified tuition program may be established and maintained only by a State or agency or instrumentality thereof.

State program, may make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified tuition program must be made in cash, and the program must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions to a qualified tuition program are not deductible. Contributions to a qualified tuition program generally are treated as a completed gift eligible for the gift tax annual exclusion.

Distributions from a qualified tuition program are not includible in the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a qualified tuition program exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over on a tax-free basis to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

Health savings accounts

Effective for taxable years beginning after December 31, 2003, a health savings account ("HSA") is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for qualified medical expenses.[17] Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and employment taxes if made by the individual's employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent, unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. A high deductible health plan is a health plan that has a deductible that is at least $1,000 for self-only coverage or $2,000 for family coverage (indexed for inflation) and that has an out-of-pocket expense limit that is no more than $5,000 in the case of self-only coverage and $10,000 in the case of family coverage.

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an Archer MSA high deductible health plan under present law, as adjusted for inflation. For 2005, the amount of the maximum deductible under an Archer MSA high deductible health plan is $2,650 in the case of self-only coverage and $5,250 in the case of family coverage. The annual contribution limits are increased for individuals who have

[17] Sec. 223.

attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

Archer medical savings accounts ("MSAs")

Like HSAs, an Archer MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for MSA purposes, a high deductible health plan is a health plan with (a) an annual deductible of at least $1,750 and no more than $2,650 in the case of self-only coverage and at least $3,500 and no more than $5,250 in the case of family coverage and (b) maximum out-of pocket expenses of no more than $3,500 in the case of self-only coverage and no more than $6,450 in the case of family coverage;[18] and (3) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

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

Description of Proposal

In general

The proposal consolidates traditional and Roth IRAs into a single type of account, a Retirement Savings Account ("RSA"). The proposal also creates a new type of account that can be used to save for any purpose, a Lifetime Savings Account ("LSA").

The tax treatment of both RSAs and LSAs is generally similar to that of present-law Roth IRAs; that is, contributions are not deductible and earnings on contributions generally are not taxable when distributed. The major difference between the tax treatment of LSAs and RSAs is that all distributions from LSAs are tax free, whereas tax-free treatment of earnings on amounts in RSAs applies only to distributions made after age 58 or in the event of death or disability.

[18] The deductible and out-of-pocket expenses dollar amounts are for 2005. These amounts are indexed for inflation in $50 increments.

Retirement Savings Accounts

Under the proposal, an individual may make annual contributions to an RSA up to the lesser of $5,000[19] or the individual's compensation for the year. As under present-law rules for IRAs, in the case of a married couple, contributions of up to the dollar limit may be made for each spouse, if the combined compensation of both spouses is at least equal to the total amount contributed for both spouses. Contributions to an RSA may be made regardless of the individual's age or adjusted gross income. Contributions to an RSA may be made only in cash. Contributions to an RSA are taken into account for purposes of the Saver's credit. Earnings on contributions accumulate on a tax-free basis.

Qualified distributions from RSAs are excluded from gross income. Under the proposal, qualified distributions are distributions made after age 58 or in the event of death or disability. Distributions from an RSA that are not qualified distributions are includible in income (to the extent that the distribution exceeds basis) and subject to a 10-percent additional tax. As under the present-law rules for Roth IRAs, distributions are deemed to come from basis first.

As under the present-law rules for Roth IRAs, no minimum distribution rules apply to an RSA during the RSA owner's lifetime. In addition, married individuals may roll amounts over from an RSA to a spouse's RSA.

Under the proposal, existing Roth IRAs are renamed RSAs and are subject to the rules for RSAs. In addition, existing traditional IRAs may be converted into RSAs . The amount converted is includible in income (except to the extent it represents a return of nondeductible contributions). No income limits apply to such conversions. For conversions of traditional IRAs made before January 1, 2007, the income inclusion may be spread ratably over four years. For conversions of traditional IRAs made on or after January 1, 2007, the income that results from the conversion is included for the year of the conversion.

Under the proposal, existing traditional IRAs that are not converted to RSAs may not accept new contributions, other than rollovers from other traditional IRAs or employer-sponsored retirement plans. New traditional IRAs may be created to accept rollovers from employer-sponsored retirement plans or other traditional IRAs, but they cannot accept any other contributions. An individual may roll an amount over directly from an employer-sponsored retirement plan to an RSA by including the rollover amount (excluding basis) in income, similar to a conversion to a Roth IRA under present law.

Amounts converted to an RSA from a traditional IRA or an Employer Retirement Savings Account ("ERSA")[20] are subject to a five-year holding period. If an amount attributable to such a conversion (other than amounts attributable to a Roth-type account in an ERSA) is distributed from the RSA before the end of the five-year period starting with the year of the conversion or, if earlier, the date on which the individual attains age 58, becomes disabled, or

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[19] The contribution limit is indexed for inflation.

[20] The proposal relating to ERSAs is discussed in Part II.A.2. of this document.

dies, an additional 10-percent tax applies to the entire amount. The five-year period is determined separately for each conversion distribution. To determine the amount attributable to a conversion, a distribution is treated as made in the following order: (1) regular RSA contributions; (2) conversion contributions (on a first-in, first-out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion.

Lifetime Savings Accounts

Under the proposal, an individual may make nondeductible contributions to an LSA of up to $5,000 annually, regardless of the individual's age, compensation, or adjusted gross income.[21] Additionally, individuals other than the LSA owner may make contributions to an LSA. The contribution limit applies to all LSAs in an individual's name, rather than to the individuals making the contributions. Thus, contributors may make annual contributions of up to $5,000 each to the LSAs of other individuals but total contributions to the LSAs of any one individual may not exceed $5,000 per year. Contributions to LSAs may be made only in cash. Contributions to an LSA are not taken into account for purposes of the Saver's credit. Earnings on contributions accumulate on a tax-free basis.

All distributions from an individual's LSA are excludable from income, regardless of the individual's age or the use of the distribution. As under the present-law rules for Roth IRAs, no minimum distribution rules apply to an LSA during the LSA owner's lifetime. In addition, married individuals may roll amounts over from an LSA to a spouse's LSA.

Control over an LSA in a minor's name is to be exercised exclusively for the benefit of the minor by the minor's parent or legal guardian acting in that capacity until the minor reaches the age of majority (determined under applicable state law).

Taxpayers may convert balances in Coverdell education savings accounts and qualified tuition programs to LSA balances on a tax-free basis before January 1, 2007, subject to certain limitations. An amount may be rolled over to an individual's LSA only if the individual was the beneficiary of the Coverdell education savings account or qualified tuition program as of December 31, 2004. The amount that can be rolled over to an LSA from a Coverdell education savings account is limited to the sum of: (1) the amount in the Coverdell education savings account as of December 31, 2004; and (2) any contributions to and earnings on the account for 2005. The amount that can be rolled over to an LSA from a qualified tuition program is limited to the sum of: (1) the lesser of $50,000 or amount in the qualified tuition program as of December 31, 2004; and (2) any contributions to and earnings on the qualified tuition program for 2005. The total amount rolled over to an individual's LSAs that is attributable to 2005

[21] Total contributions to an LSA for a year may not exceed $5,000, regardless of whether any distributions are taken from the LSA during the year. The contribution limit is indexed for inflation.

contributions for the individual to Coverdell education savings accounts and qualified tuition programs cannot exceed $5,000 (plus any earnings on such contributions).

Under the proposal, qualified tuition programs continue to exist as separate arrangements, but may be offered in the form of an LSA. For example, State agencies that administer qualified tuition programs may offer LSAs with the same investment options that are available under the qualified tuition program. The annual limit on LSA contributions apply to such an LSA, but the additional reporting requirements applicable to qualified tuition programs under present law do not apply and distributions for purposes other than education are not subject to Federal tax.[22]

Effective date

The proposal is effective on January 1, 2006.

Analysis

In general

The proposal is intended to accommodate taxpayers' changing circumstances over time by providing a new account that taxpayers may use for tax-favored saving over their entire lifetimes, with no restrictions on withdrawals. The proposal also provides a new account for individual retirement savings with fewer restrictions on eligibility than present-law IRAs. The proposal is intended to simplify saving by permitting the consolidation of existing savings accounts into these accounts and allowing individuals to make contributions to the new accounts with no limitations based on age or income level.

By providing additional tax incentives for saving, the proposal intends to encourage additional saving generally.[23] By providing a tax-favored savings account with no restrictions on withdrawals, the proposal intends to encourage additional saving in particular by those who are reluctant to take advantage of existing tax-preferred savings accounts because of withdrawal restrictions. Some argue that the national saving rate is too low, and that this is due in part to the bias of the present-law income tax structure against saving and in favor of current consumption. By providing tax incentives for saving - specifically, removing the tax on the return to saving - the present-law income tax structure can be modified to function more like a consumption tax. Proponents of such tax incentives argue that saving will increase if the return to saving is not reduced by taxes. Others have argued that saving has not necessarily increased as a result of existing tax incentives for savings. Some have argued that much existing savings have merely

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[22] State tax law and qualified tuition program investment options may provide incentives for savings used for educational purposes.

[23] The Treasury Department expects that, beginning with the 2007 filing season for individual income tax returns, taxpayers will be able to direct that a portion of their refunds be deposited into an LSA or RSA.

been shifted into tax-favored accounts, and thus do not represent new saving.[24] Also, it may be advantageous to borrow in order to fund tax-favored saving vehicles. To the extent that borrowing occurs to fund these accounts, no net saving occurs. Ideally, saving incentives should apply only to net new saving, in order to avoid windfall gains to existing savings. However, measuring net saving would be difficult in practice.

Others have argued that increasing the return to savings (by not taxing earnings) might cause some taxpayers actually to save less, as a higher return to savings means that less saving is necessary to achieve a "target" level of savings at some point in the future.

From an economic perspective, both LSAs and RSAs receive tax treatment generally equivalent to Roth IRAs. While the taxpayer does not deduct contributions to LSAs, tax is never paid on the income earned on the investment. The same is generally true for RSAs as long as amounts are withdrawn in qualified distributions. However, while LSAs and RSAs receive similar tax treatment to Roth IRAs, the maximum allowable annual contribution is greater than the amount of contributions currently permitted to Roth IRAs. The increase in the amounts that may be contributed to tax-preferred savings accounts provides a tax incentive for further saving for those who have already contributed the maximum to existing tax-favored savings accounts. However, for taxpayers not already contributing the maximum amounts, the new accounts provide no additional economic inducement to save, except to the extent that the LSAs provide withdrawal flexibility relative to existing retirement savings vehicles' age restrictions.[25] Opponents of proposals to increase tax-favored saving thus argue that the only beneficiaries are likely to be wealthy taxpayers with existing savings that will be shifted to the tax-favored accounts, since most taxpayers have not taken full advantage of existing saving incentives.

RSAs also replace traditional IRAs and thereby eliminate taxpayers' ability to make deductible contributions. From an economic perspective, RSAs receive tax treatment generally equivalent to traditional IRAs to which deductible contributions are made.[26] However, some

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[24] Unlike present-law IRAs, an LSA does not require that contributions be no greater than compensation. Under the proposal, regardless of income, an individual may make nondeductible annual contributions to an LSA of up to $5,000. To the extent an individual makes contributions to his or her own LSA that exceed his or her income, then the amounts transferred in excess of income must represent a transfer of assets from existing savings and not new savings from forgoing current consumption. Additionally, individuals other than the LSA owner may make contributions to an LSA.

[25] Some argue that contributions to deductible IRAs declined substantially after 1986 for taxpayers whose eligibility to contribute to deductible IRAs was not affected by the income-related limits introduced in 1986, because financial institutions cut back on promoting contributions as a result of the general limits on deductibility. Thus, they would argue, universally available tax-preferred accounts such as LSAs and RSAs will increase saving at all income levels.

[26] Whether an RSA and a traditional IRA to which deductible contributions are made are in fact economically equivalent depends on the difference between the taxpayer's marginal tax

would argue that the upfront deduction provides a greater psychological inducement to save, and that the elimination of traditional IRAs may reduce saving by those who would have been able to make deductible contributions.

Taxpayers may convert balances under Coverdell education savings accounts and qualified tuition programs into LSAs on a tax-free basis before January 1, 2007. Under the proposal, existing balances in Coverdell education savings accounts and existing balances in qualified tuition programs (up to $50,000) may be converted to LSA balances with no income tax consequences. This means that pretax earnings accumulated on Coverdell education savings accounts and qualified tuition program balances that are converted to LSAs may be withdrawn and spent for purposes other than education without the income tax consequences applicable to Coverdell education savings account and qualified tuition program distributions that are used for nonqualifying expenses. Conversion allows the consolidation of saving into a single vehicle for simplification purposes. However, there is some scope for abuse of this conversion option. A taxpayer with sufficient resources may effect such a conversion simply to shift more saving into tax-favored accounts. For example, a taxpayer could transfer $50,000 from an existing qualified tuition program into an LSA, and then reinvest a different $50,000 into the qualified tuition program.

The tax treatment of contributions under qualified retirement plans is essentially the same as that of traditional IRAs to which deductible contributions are made. 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. A 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.

Some argue that offering LSAs and RSAs will reduce the incentive for small business owners to maintain qualified retirement plans for themselves and their employees. A business owner can generally contribute more to a qualified plan than the contributions that may be made to LSAs and RSAs, but only if comparable contributions are made by or on behalf of rank-and-file employees. The business owner must therefore successfully encourage rank-and-file employees to contribute to the plan or, in many cases, make matching or nonelective contributions for rank-and-file employees. The opportunity to contribute $5,000 annually to both an LSA and an RSA for both the business owner and his or her spouse, without regard to adjusted gross income or contributions for rank-and-file employees, may be a more attractive alternative to maintaining a qualified retirement plan. Others argue that many employers

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rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. When marginal rates decrease over time (because tax rates change generally or taxpayers fall into lower tax brackets), a traditional IRA to which deductible contributions are made is more advantageous than an RSA because the traditional IRA permits taxpayer to defer payment of tax until rates are lower. When marginal tax rates increase over time, an RSA is more advantageous.

(including small employers) offer qualified retirement plans to attract and retain high-quality employees and will continue to do so. Some raise concerns that, as a substitute for a qualified retirement plan, an employer could selectively choose to pay additional compensation only to highly compensated employees in the form of contributions to LSAs and RSAs. This may undermine the principle of promoting savings for rank-and-file employees.

Thus, some argue that the proposal may reduce qualified retirement plan coverage, particularly in the case of small businesses. Whether any reduced coverage would result in an overall reduction of retirement security would depend, in part, on the extent to which individuals who are not covered by a qualified retirement plan instead contribute to the new savings vehicles.

Complexity

The proposal has elements that may both increase and decrease tax law complexity. On one hand, the proposal provides new savings options to individuals, which may increase complexity to the extent that taxpayers open new LSAs and RSAs without consolidating existing tax-preferred savings into such accounts. In addition, although the proposal relating to RSAs generally precludes future contributions to traditional IRAs, the proposal relating to LSAs does not preclude future contributions to present-law tax-favored arrangements for certain purposes, such as Coverdell education savings accounts, qualified tuition programs, and health savings accounts. On the other hand, the proposal may decrease complexity by permitting consolidation of tax-favored savings accounts.

Additionally, with respect to future saving, in one respect choices are made easier by the elimination of the need to decide whether to make deductible or nondeductible IRA contributions for those taxpayers eligible to contribute to both. However, employer-sponsored qualified retirement plans generally receive the same tax treatment as traditional IRAs to which deductible contributions are made (i.e., contributions are not taxable, but distributions are). Therefore, the increased availability of Roth-type savings vehicles, in terms of eligibility to make contributions and higher contribution limits, is likely to mean that many more taxpayers will face a choice of how to balance their savings between deductible and nondeductible savings vehicles. Nonetheless, the ability to make contributions to LSAs and RSAs without limitations based on age or income level, the uniform tax treatment of all contributions to LSAs and RSAs, and the lack of restrictions on LSA withdrawals, are likely to decrease complexity.

Prior Action

The President's fiscal year 2005 budget proposals included a similar proposal. The President's fiscal year 2004 budget proposals included a similar proposal; among the differences are that in the fiscal year 2004 proposal, the annual dollar limit on contributions to RSAs or to LSAs was $7,500.

2. Consolidation of employer-based savings accounts

Present Law

In general

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

Qualified retirement plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (i.e., a section 401(k) plan), employees may elect to make pretax contributions to a plan. Such contributions are referred to as elective deferrals. Employees may also make after-tax contributions to a qualified retirement plan. Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to be qualified and for the favorable tax treatment to apply. These requirements include nondiscrimination rules that are intended to ensure that a qualified retirement plan covers a broad group of employees. Certain of these rules are discussed in more detail, below.

Qualified retirement plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided. Under a defined benefit plan, benefits are determined under a plan formula, generally based on compensation and years of service. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant.

In addition to qualified section 401(k) plans, present law provides for other types of employer-sponsored plans to which pretax employee elective contributions can be made. Many of these arrangements are not qualified retirement plans, but receive the same tax-favored treatment as qualified retirement plans. The rules applicable to each type of arrangement vary. These arrangements include SIMPLE section 401(k) plans, tax-sheltered annuity plans

("section 403(b) plans"),[27] governmental eligible deferred compensation plans ("section 457 plans"),[28] SIMPLE IRAs,[29] and salary-reduction simplified employee pensions ("SARSEPs").[30]

Limits on contributions to qualified defined contribution plans

The annual additions under a defined contribution plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation ($42,000 for 2005). Annual additions are the sum of employer contributions,[31] employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Nondiscrimination requirements applicable to qualified retirement plans

The nondiscrimination requirements are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.[32] Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.[33] Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules. Under the regulations, the amount of contributions or benefits provided under the plan and the benefits, rights and features offered under the plan must be tested.[34]

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[27] Sec. 403(b).

[28] Sec. 457.

[29] Sec. 408(p).

[30] Sec. 408(k).

[31] Elective deferrals are treated as employer contributions for this purpose.

[32] For purposes of the nondiscrimination requirements, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $95,000 (for 2005) or (b) at the election of the employer had compensation for the preceding year in excess of $95,000 (for 2005) and was in the top 20 percent of employees by compensation for such year (sec. 414(q)). A nonhighly compensated employee is an employee other than a highly compensated employee.

[33] Sec. 401(a)(4). A qualified retirement plan of a State or local governmental employer is not subject to the nondiscrimination requirements.

[34] See Treas. Reg. sec. 1.401(a)(4)-1.

Treasury regulations provide three general approaches to testing the amount of nonelective contributions provided under a defined contribution plan: (1) design-based safe harbors; (2) a general test; and (3) cross-testing.[35] Elective deferrals, matching contributions, and after-tax employee contributions are subject to separate testing as described below.

Qualified cash or deferred arrangements (section 401(k) plans)

In general

Section 401(k) plans are subject to the rules generally applicable to qualified defined contribution plans.[36] In addition, special rules apply.

As described above, an employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an individual is $14,000 for 2005.[37] An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan. As a result, the limit on elective deferrals is increased for an individual who has attained age 50 by $4,000 for 2005.[38] An employee's elective deferrals must be fully vested.

Special nondiscrimination tests

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the "ADP" test.[39] The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral

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[35] See Treas. Reg. sec. 1.401(a)(4)-2(b) and (c) and sec. 1.401(a)(4)-8(b).

[36] Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

[37] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased many of the limits applicable to employer-sponsored retirement plans, generally effective for years beginning after December 31, 2001. Under EGTRRA, the dollar limit on elective deferrals increases to $14,000 for 2005 and $15,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[38] The additional amount permitted for catch-up contributions increases to $4,000 for 2005 and $5,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The catch-up contribution provisions are subject to the general sunset provision of EGTRRA.

[39] Sec. 401(k)(3).

percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a "safe harbor section 401(k) plan").[40] A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Alternatively, the matching contribution requirement is met if (1) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (2) the aggregate amount of matching contributions at such rate of employee elective deferral is at least equal to the aggregate amount of matching contributions that would be made if matching contributions were made on the basis of the percentages described in the preceding formula. A plan does not meet the contributions requirement if the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is greater than the rate of matching contribution with respect to the same rate of elective deferral of a nonhighly compensated employee.

Nondiscrimination tests for matching contributions and after-tax employee contributions

Employer matching contributions and after-tax employee contributions are also subject to a special annual nondiscrimination test, the "ACP test".[41] The ACP test compares the actual contribution percentages ("ACPs") of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are

[40] Sec. 401(k)(12).

[41] Sec. 401(m).

eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

A safe harbor section 401(k) plan is deemed to satisfy the ACP test with respect to matching contributions, provided that (1) matching contributions are not provided with respect to elective deferrals or after-tax employee contributions in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals or after-tax contributions increases, and (3) the rate of matching contribution with respect to any rate of elective deferral or after-tax employee contribution of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral or contribution of a nonhighly compensated employee.

Tax-sheltered annuities (section 403(b) plans)

Section 403(b) plans are another form of employer-based retirement plan that provide the same tax benefits as qualified retirement plans. Employers may contribute to such plans on behalf of their employees, and employees may make elective deferrals. Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Some of the rules that apply to section 403(b) plans are similar to rules applicable to qualified retirement plans.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals (and catch-up contributions) under a section 401(k) plan. If contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the contributions under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, additional elective deferrals are permitted under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church or convention of churches in the case of employees who have completed 15 years of service.

Section 403(b) plans are generally subject to the minimum coverage and general nondiscrimination rules that apply to qualified defined contribution plans. In addition, employer matching contributions and after-tax employee contributions are subject to the ACP test. However, pretax contributions made by an employee under a salary reduction agreement (i.e., contributions that are comparable to 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.[42]

Eligible deferred compensation plans of State and local governments (section 457 plans)

Compensation deferred under a section 457 plan of a State or local governmental employer is includible in income when paid.[43] The maximum annual deferral under such a plan generally is the lesser of (1) $14,000 for 2005 (increasing to $15,000 for 2006) or (2) 100 percent of compensation. A special, higher limit applies for the last three years before a participant reaches normal retirement age (the "section 457 catch-up limit"). In the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of $4,000 for 2005 (increasing to $5,000 by 2006), unless a higher section 457 catch-up limit applies. Only contributions to section 457 plans are taken into account in applying these limits; contributions made to a qualified retirement plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457 plan for that employee.

SIMPLE retirement plans

Under present law, a small business that employs fewer than 100 employees can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE plan can be either an individual retirement arrangement for each employee (a "SIMPLE IRA") or part of a section 401(k) plan (a "SIMPLE section 401(k) plan").

A SIMPLE retirement plan allows employees to make elective deferrals, subject to a limit of $10,000 for 2005. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE plan up to a limit of $2,000 for 2005 (increasing to $2,500 for 2006).

Employer contributions to a SIMPLE plan must 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 three percent of the employee's compensation. Under a special rule applicable only to SIMPLE IRAs, the employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than two out of any five years. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a two 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.

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[42] As in the case of a qualified retirement plan, a section 403(b) plan of a State or local governmental employer is not subject to the nondiscrimination rules.

[43] Section 457 applies also to deferred compensation plans of tax-exempt entities. Those plans are not affected by the proposal; only the rules for governmental section 457 plans are relevant for purposes of this discussion.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan and the employer may not maintain any other plan. All contributions to an employee's SIMPLE account must be fully vested.

In the case of a SIMPLE IRA, the group of eligible employees generally must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. A SIMPLE IRA is not subject to the nondiscrimination rules generally applicable to qualified retirement plans. In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans. A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

Salary reduction simplified employee pensions ("SARSEPs")

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to defined contribution plans. All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee (1) has attained age 21, (2) has performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $450 (for 2005) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation. For this purpose permitted disparity may be taken into account.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP (a "SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($14,000 for 2005, increasing to $15,000 for 2006). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $2,000 for 2005 (increasing to $2,500 for 2006).

Designated Roth contributions

There are two general types of individual retirement arrangements ("IRAs") under present and prior law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to $10,000). A distribution from a

Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).

Beginning in 2006, a section 401(k) plan or a section 403(b) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe) as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for certain purposes, including the nondiscrimination requirements applicable to section 401(k) plans.

A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

Description of Proposal

In general

Under the proposal, the various present-law employer-sponsored retirement arrangements under which individual accounts are maintained for employees and employees may make contributions are consolidated into a single type of arrangement called an employer retirement savings account (an "ERSA"). An ERSA is available to all employers and is subject to simplified qualification requirements.

Employer Retirement Savings Accounts

In general

The rules applicable to ERSAs generally follow the present-law rules for section 401(k) plans with certain modifications. Existing section 401(k) plans and thrift plans are renamed ERSAs and continue to operate under the new rules. Existing section 403(b) plans, governmental eligible section 457 plans, SARSEPs, and SIMPLE IRAs and SIMPLE section 401(k) plans may be renamed ERSAs and operate under the new rules. Alternatively, such arrangements may continue to be maintained in their current form, but may not accept any new employee deferrals or after-tax contributions after December 31, 2006.[44]

[44] Special transition rules are to be provided for plans maintained pursuant to collective bargaining agreements and for plans sponsored by State and local governments.

Types of contributions and treatment of distributions

An ERSA may provide for an employee to make pretax elective contributions and catch-up contributions up to the present-law limits applicable to a section 401(k) plan, that is, a limit of $14,000 for elective deferrals made in 2005 (increasing to $15,000 for 2006) and a limit of $4,000 for catch-up contributions in 2005 (increasing to $5,000 for 2006). An ERSA may also allow an employee to designate his or her elective contributions as Roth contributions or to make other after-tax employee contributions. An ERSA may also provide for matching contributions and nonelective contributions. Total annual contributions to an ERSA for an employee (including employee and employer contributions) may not exceed the present-law limit of the lesser of 100 percent of compensation or $42,000 (as indexed for future years).

Distributions from an ERSA of after-tax employee contributions (including Roth contributions) and qualified distributions of earnings on Roth contributions are not includible in income. All other distributions are includible in income.

Nondiscrimination requirements

The present-law ADP and ACP tests are replaced with a single nondiscrimination test. If the average contribution percentage for nonhighly compensated employees is six percent or less, the average contribution percentage for highly compensated employees cannot exceed 200 percent of the nonhighly compensated employees' average contribution percentage. If the average contribution percentage for nonhighly compensated employees exceeds six percent, the nondiscrimination test is met. For this purpose, a "contribution percentage" is calculated for each employee as the sum of employee pretax and after-tax contributions, employer matching contributions, and qualified nonelective contributions made for the employee, divided by the employee's compensation.

A design-based safe harbor is available for an ERSA to satisfy the nondiscrimination test. Similar to the section 401(k) safe harbor under present law, under the ERSA safe harbor, the plan must be designed to provide all eligible nonhighly compensated employees with either (1) a fully vested nonelective contribution of at least three percent of compensation, or (2) fully vested matching contributions of at least three percent of compensation, determined under one of two formulas. The ERSA safe harbor provides new formulas for determining required matching contributions. Under the first formula, matching contributions must be made at a rate of 50 percent of an employee's elective contributions up to six percent of the employee's compensation. Alternatively, matching contributions may be made under any other formula under which the rate of matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions that would be made if matching contributions were made on the basis of the percentages described in the first formula. In addition, the rate of matching contribution with respect to any rate of elective contribution cannot be higher for a highly compensated employee than for a nonhighly compensated employee.

A plan sponsored by a State or local government is not subject to the nondiscrimination requirements. In addition, a plan sponsored by an organization exempt from tax under section

501(c)(3) is not subject to the ERSA nondiscrimination tests (unless the plan permits after-tax or matching contributions), but must permit all employees of the organization to participate.

Special rule for small employers

Under the proposal, an employer that employed 10 or fewer employees with compensation of at least $5,000 in the prior year is able to offer an ERSA in the form of custodial accounts for employees (similar to a present-law IRA), provided the employer's contributions satisfy the ERSA design-based safe harbor described above. The option of using custodial accounts under the proposal provides annual reporting relief for small employers as well as relief from most fiduciary requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") under circumstances similar to the relief provided to sponsors of SIMPLE IRAs under present law.

Effective date

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

Analysis

In general[45]

An employer's decision to establish or continue a retirement plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for certain employer-sponsored retirement plans in order to further retirement income policy by encouraging the establishment and continuance of plans that provide broad coverage, including rank-and-file employees. On the other hand, tax policy is concerned also with the level of tax subsidy provided to retirement plans. Thus, the tax law limits the total amount that may be provided to any one employee under a tax-favored retirement plan and includes strict nondiscrimination rules to prevent highly compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to employer-sponsored retirement plans.

The rules governing employer-sponsored retirement plans, particularly the nondiscrimination rules, are generally regarded as complex. Some have argued that this complexity deters employers from establishing qualified retirement plans or causes employers to terminate such plans. Others assert that the complexity of the rules governing employer-sponsored retirement plans is a necessary byproduct of attempts to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer and to provide employers, particularly large employers, with the flexibility needed to recognize differences in the way that employers do business and differences in workforces.

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[45] For a detailed discussion of complexity issues related to retirement savings, see, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

Analysis of ERSA proposal

General nondiscrimination test

The special nondiscrimination rules for 401(k) plans are designed to ensure that nonhighly compensated employees, as well as highly compensated employees, receive benefits under the plan. The nondiscrimination rules give employers an incentive to make the plan attractive to lower- and middle-income employees (e.g., by providing a match or qualified nonelective contributions) and to undertake efforts to enroll such employees, because the greater the participation by such employees, the more highly compensated employees can contribute to the plan.

Some argue that the present-law nondiscrimination rules are unnecessarily complex and discourage employers from maintaining retirement plans. By reducing the complexity associated with ADP and ACP testing and reducing the related compliance costs associated with a plan, the proposal arguably makes employers more likely to offer retirement plans, thus increasing coverage and participation. Others argue that the present-law section 401(k) safe harbor already provides a simplified method of satisfying the nondiscrimination requirements without the need to run the ADP and ACP tests. Some also point out that the proposal allows a greater differential in the contribution rates for highly and nonhighly compensated employees under an ERSA than the present-law rules for section 401(k) plans. They argue that this weakens the nondiscrimination rules by enabling employers to provide greater contributions to highly paid employees than under present law without a corresponding increase in contributions for rank-and-file employees. They also argue that the proposal reduces the incentive for employers to encourage nonhighly compensated employees to participate in the plan, which could result in lower contributions for rank-and-file employees. On the other hand, others believe that allowing contributions to favor highly paid employees more than under present law is appropriate in order to encourage employers to maintain plans that benefit rank-and-file employees.

ERSA safe harbor

The present-law safe harbors for elective deferrals and matching contributions were designed to achieve the same objectives as the special nondiscrimination tests for these amounts, but in a simplified manner. The alternative of a nonelective contribution of three percent ensures a minimum benefit for all employees covered by the plan, while the alternative of matching contributions at a higher rate (up to four percent) was believed to be sufficient incentive to induce participation by nonhighly compensated employees. It was also hoped that the safe harbors would reduce the complexities associated with qualified plans, and induce more employers to adopt retirement plans for their employees.

To the extent that the ERSA safe harbor requires an employee's elective deferrals to be matched at only a 50 percent rate and requires a total of only three percent in matching contributions, some argue that the proposal not only weakens the matching contribution alternative under the safe harbor, but also makes that alternative clearly less expensive for the employer than the nonelective contribution alternative, thereby reducing the incentive for an employer to provide nonelective contributions. In addition, because, as under the present-law safe harbor, the matching contribution alternative is satisfied by offering matching contributions

(without regard to the amount actually provided to nonhighly compensated employees), some argue that employers may no longer have a financial incentive to encourage employees to participate. This may reduce participation by rank-and-file employees. The argument may also be made that the matching contribution requirement under the ERSA safe harbor is less rigorous than the matching contribution requirement that applies to a SIMPLE plan under present law, even though an ERSA is not subject to the limitations on SIMPLE arrangements (i.e., contributions are subject to lower limits and SIMPLEs are available only to small employers). On the other hand, some believe that the present law safe harbor for section 401(k) plans has failed to provide an adequate incentive for employers to offer retirement plans to their employees and further incentive is needed. Some argue that the proposal makes the safe harbor more attractive for employers, especially small employers, and will thus increase coverage and participation.

Consolidation of various types of employer-sponsored plans

One of the sources of complexity in the present-law rules relating to employer-sponsored retirement plans is the existence of numerous vehicles with similar purposes but different rules.[46] Thus, employers desiring to adopt a retirement plan must determine which vehicles are available to that employer and which of the various vehicles available it wishes to adopt. This determination may entail a costly and time-consuming analysis and comparison of a number of different types of plans. By providing only one type of defined contribution plan to which employee contributions may be made, i.e., an ERSA, the proposal makes it easier for employers to determine whether to adopt a plan and what type of plan to provide. Having a single type of plan may also make it easier for employees to understand their retirement benefits, particularly when employees change jobs.

On the other hand, many employers already have plans and are familiar with the present-law rules applicable to their plans. Converting a present-law arrangement to an ERSA will involve administrative costs, which some employers may not view as commensurate with simplification benefits.

Many view the different rules for different types of plans as largely historical in nature and as adding complexity without serving an overriding policy objective. On the other hand, some argue that the differences in the rules serve different employment objectives and policies of different types of employers.

Some may be concerned that the proposal, in combination with the proposals for expanded individual savings opportunities (i.e., Lifetime Savings Accounts and Retirement

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[46] This issue is discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001. See Vol. II, Part III.A.1. (General simplification issues, at 149-150), and Part III.C.5. (Sources of Complexity, at 186) and in Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), Jan. 2005, Part IV.E, at 122-129.

Savings Accounts), will further reduce the incentive for small employers to offer retirement plans to their employees.[47] Although higher contributions may be made to an employer-sponsored retirement plan than to these other arrangements, comparable contributions must be made by or on behalf of rank-and-file employees. The opportunity to contribute $5,000 a year to both a Lifetime Savings Account and a Retirement Savings Account for both the business owner and his or her spouse, without regard to adjusted gross income or contributions for rank-and-file employees, may be a more attractive alternative to maintaining a qualified retirement plan. On the other hand, the excludability of ERSA contributions and the availability of the ERSA safe harbor, coupled with the higher contribution levels permitted under a qualified plan, may be viewed as providing an adequate incentive for a small employer to establish an ERSA.

Prior Action

The President's fiscal years 2004 and 2005 budget proposals included similar proposals. In addition, the President's fiscal year 2004 budget included several proposals to simplify the rules for defined contribution plans generally.

3. Individual development accounts

Present Law

Individual development accounts were first authorized by the Personal Work and Responsibility Act of 1996. In 1998, the Assets for Independence Act established a five-year $125 million demonstration program to permit certain eligible individuals to open and make contributions to an individual development account. Contributions by an individual to an individual development account do not receive a tax preference but are matched by contributions from a State program, a participating nonprofit organization, or other "qualified entity." The IRS has ruled that matching contributions by a qualified entity are a gift and not taxable to the account owner.[48] The qualified entity chooses a matching rate, which must be between 50 and 400 percent. Withdrawals from individual development account can be made for certain higher education expenses, a first home purchase, or small business capitalization expenses. Matching contributions (and earnings thereon) typically are held separately from the individuals' contributions (and earnings thereon) and must be paid directly to a mortgage provider, educational institution, or business capitalization account at a financial institution. The Department of Health and Human Services administers the individual development account program.

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[47] The proposals relating to Lifetime Savings Accounts and Retirement Savings Accounts are discussed in Part II.A.1. of this document.

[48] Rev. Rul. 99-44, 1999-2 C.B. 549.

Description of Proposal

The proposal provides a nonrefundable tax credit for a qualified entity (i.e., qualified financial institutions, qualified nonprofit organizations, and qualified Indian tribes)[49] that has an individual development account program in a taxable year. The tax credit equals the amount of matching contributions made by the eligible entity under the program (up to $500 per account per year) plus $50 for each individual development account maintained during the year under the program. Except in the first year that each account is open, the $50 credit is available only for accounts with a balance of more than $100 at year-end. The amount of the credit is adjusted for inflation after 2007. The $500 amount is rounded to the nearest multiple of twenty dollars. The $50 amount is rounded to the nearest multiple of five dollars. No deduction or other credit is available with respect to the amount of matching funds taken into account in determining the credit.

The credit applies with respect to the first 900,000 individual development accounts opened after December 31, 2006 and before January 1, 2012, and with respect to matching funds for participant contributions that are made after December 31, 2006, and before January 1, 2014.

Nonstudent U.S. citizens or legal residents between the ages of 18 and 60 (inclusive) who are not dependents of a taxpayer and who meet certain income requirements are eligible to open and contribute to an individual development account. The income limit is modified adjusted gross income of $20,000 for single filers, $40,000 for joint filers, and $30,000 for head-of-household filers.[50] Eligibility in a taxable year is based on the previous year's modified adjusted gross income and circumstances (e.g., status as a student). Modified adjusted gross income is adjusted gross income, plus certain items that are not includible in gross income. The proposal does not specify which items are to be added. The income limits are adjusted for inflation after 2007. This amount is rounded to the nearest multiple of 50 dollars.

Under the proposal, an individual development account must: (1) be owned by the eligible individual for whom the account was established; (2) consist only of cash contributions; (3) be held by a person authorized to be a trustee of any individual retirement account under section 408(a)(2)); and (4) not commingle account assets with other property (except in a common trust fund or common investment fund). These requirements must be reflected in the written governing instrument creating the account. The entity establishing the program is required to maintain separate accounts for the individual's contributions (and earnings therein) and matching funds and earnings thereon.

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[49] If the qualified entity is tax-exempt, other persons may claim the credit as provided for in Treasury regulations.

[50] Married taxpayers filing separate returns are not eligible to open an IDA or to receive matching funds for an IDA that is already open.

Contributions to individual development accounts by individuals are not deductible and earnings thereon are taxable to the account holder. Matching contributions and earnings thereon are not taxable to the account holder.

The proposal permits individuals to withdraw amounts from an individual development account for qualified expenses of the account owner, owner's spouse, or dependents. Withdrawals other than for qualified expenses ("nonqualified" withdrawals) may not be made from the portion of the accounts attributable to the matching contributions before the account owner attains age 61. In addition, nonqualified withdrawals from the portion of the account attributable to the individual contributions may result in forfeiture of some or all of the amounts attributable to matching contributions. Qualified expenses include: (1) qualified higher education expenses (as generally defined in section 529(e)(3)**;** (2) first-time homebuyer costs (as generally provided in section 72 (t)(8); (3) business capitalization or expansion costs (expenditures made pursuant to a business plan that has been approved by the financial institution, nonprofit, or Indian tribe); (4) rollovers of the balance of the account (including the parallel account) to another individual development account for the benefit of the same owner; and (5) final distributions in the case of a deceased account owner. Withdrawals for qualified home and business capitalization expenses must be paid directly to another financial institution. Withdrawals for qualified educational expenses must be paid directly to the educational institution. Such withdrawals generally are not permitted until the account owner completes a financial education course offered by a qualified financial institution, qualified nonprofit organization, qualified Indian tribe or governmental entity. The Secretary of the Treasury (the "Secretary") is required to establish minimum standards for such courses. Withdrawals for nonqualified expenses may result in the account owner's forfeiture of some amount of matching funds.

The qualified entity administering the individual development account program is generally required to make quarterly payments of matching funds on a dollar-for-dollar basis for the first $500 contributed by the account owner in a taxable year. This dollar amount is adjusted for inflation after 2007. Matching funds may be provided also by State, local, or private sources. Balances of the individual development account and parallel account are reported annually to the account owner. If an account owner ceases to meet eligibility requirements, matching funds generally are not contributed during the period of ineligibility. Any amount withdrawn from a parallel account is not includible in an eligible individual's gross income or the account sponsor's gross income.

Qualified entities administering a qualified program are required to report to the Secretary that the program is administered in accordance with legal requirements. If the Secretary determines that the program is not so operated, the Secretary has the power to terminate the program. Qualified entities also are required to report annually to the Secretary information about: (1) the number of individuals making contributions to individual development accounts; (2) the amounts contributed by such individuals; (3) the amount of matching funds contributed; (4) the amount of funds withdrawn and for what purpose; (5) balance information; and (6) any other information that the Secretary deems necessary.

The Secretary is authorized to prescribe necessary regulations, including rules to permit individual development account program sponsors to verify eligibility of individuals seeking to

open accounts. The Secretary is also authorized to provide rules to recapture credits claimed with respect to individuals who forfeit matching funds.

Effective date.–The proposal is effective for taxable years ending after December 31, 2006, and beginning before January 1, 2014.

Analysis

Policy issues

The proposal is intended to encourage individuals to save by providing a subsidy to saving. Proponents argue that many individuals have sufficiently low income that saving is difficult, and that the subsidy will help these individuals to accumulate savings, as well as to become more financially literate through the programs required to be provided by the eligible entities that may offer IDAs.

Opponents may argue that the generosity of the subsidy, which provides an immediate 100 percent return to the individual's contribution, makes the program more like an income transfer program and does not provide a realistic picture of the normal returns to saving. Others note that the cap on the number of accounts to which the credit applies creates the potential for unequal tax treatment of similarly situated individuals, and may effectively allow financial and other eligible institutions to pick and choose among potential beneficiaries of the individual development account program. Additionally, individuals without ready access to eligible institutions are disadvantaged with respect to the ability to benefit under the proposal.

Complexity issues

In general, adding a new credit to the tax law will tend to increase the complexity of the tax law and will require additional Treasury or other Governmental resources to be devoted to administration of the provisions and to enforcement activities. The individual development account proposal requires additional record keeping by financial institutions benefiting from the credit and also by account holders. The annual reporting requirements of the individual development account program will increase the paperwork burden on individuals and financial institutions utilizing the provision. Arguably, the proposal will also add complexity in that it will increase the number of savings incentives in the tax law, each with different requirements. Some might argue that consolidation of these incentives will serve to simplify tax law and tax administration.

Prior Action

Similar proposals were included in the President's fiscal year 2002, 2003, 2004, and 2005 budget proposals.

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, included a similar proposal.

B. Health Care Provisions

1. Refundable tax credit for the purchase of health insurance

Present Law

In general

Present law contains a number of provisions dealing with the Federal tax treatment of health expenses and health insurance coverage. The tax treatment of health insurance expenses depends on whether a taxpayer is covered under a health plan paid for by an employer, whether an individual has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold. The tax benefits available with respect to health care expenses also depends on the type of coverage.

Exclusion for employer-provided coverage

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[51] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care.[52] If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan is also excludable from an employee's gross income and wages.[53] A cafeteria plan allows employees to choose between cash and certain nontaxable benefits, including health coverage. Through the use of a cafeteria plan, employees can pay for health coverage on a salary reduction basis.

Present law provides for two general employer-provided arrangements that can be used to pay for or reimburse medical expenses of employees on a tax-favored basis: flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs"). While these arrangements provide similar tax benefits (i.e., the amounts paid under the arrangements for medical care are excludable from gross income and wages for employment tax purposes), they are subject to different rules. A main distinguishing feature between the two arrangements is that while FSAs are generally part of a cafeteria plan and contributions to FSAs are made on a salary

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[51] Secs. 106, 3121(a)(2), and 3306(b)(2).

[52] Sec. 105. In the case of a self-insured medical reimbursement arrangement, the exclusion applies to highly compensated employees only if certain nondiscrimination rules are satisfied. Sec. 105(h). Medical care is defined as under section 213(d) and generally includes amounts paid for qualified long-term care insurance and services.

[53] Secs. 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

reduction basis, HRAs cannot be part of a cafeteria plan and contributions cannot be made on a salary-reduction basis.[54] In addition, amounts in an HRA may be used to purchase insurance as well as to reimburse expenses not covered by insurance, while amounts in an FSA cannot be used for insurance, but are used to pay for expenses not coverage by insurance.

Deduction for health insurance expenses of self-employed individuals

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership)[55] are entitled to deduct 100 percent of the amount paid for health insurance for themselves and their spouse and dependents for income tax purposes.[56]

Itemized deduction for medical expenses

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year for health insurance (to the extent not reimbursed by insurance or otherwise) for the taxpayer, the taxpayer's spouse, and dependents, only to the extent that the taxpayer's total medical expenses, including health insurance premiums, exceeds 7.5 percent of the taxpayer's adjusted gross income.[57]

Health care tax credit

Under the Trade Adjustment Assistance Reform Act of 2002,[58] certain individuals are eligible for the health coverage tax credit ("HCTC"). The HCTC is a refundable tax credit for 65 percent of the cost of qualified health coverage paid by an eligible individual. In general, eligible individuals are individuals receiving a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 and receiving pension benefits from the Pension Benefit Guaranty Corporation. The credit is available for "qualified health insurance," which includes certain employer-based insurance, certain State-based insurance, and in some cases,

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[54] Notice 2002-45, 2002-28 I.R.B. 93 (July 15, 2002); Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (July 15, 2002).

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

[56] Sec. 162(l). The deduction does not apply for self-employment tax (SECA) purposes.

[57] Sec. 213. The adjusted gross income percentage is 10 percent for purposes of the alternative minimum tax. Sec. 56(b)(1)(B).

[58] Pub. L. No. 107-210, secs. 201(a), 202 and 203 (2002).

insurance purchased in the individual market. The credit is available on an advance basis through a program established by the Secretary.

Health savings accounts

In general

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003[59] allows individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) to establish a health savings account ("HSA"). An HSA is a tax-exempt trust or custodial account. In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses.

Eligible individuals

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan and which provides coverage for any benefit which is covered under the high deductible health plan. Individuals entitled to benefits under Medicare are not eligible to make contributions to an HSA. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return. An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage.[60]

A high deductible health plan is a health plan that has a deductible for 2005 that is at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit that is no more than $5,100 in the case of self-only coverage and $12,000 in the case of family coverage.[61] A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

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[59] Pub. L. No. 108-173 (2003).

[60] Permitted insurance is: (1) 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; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

[61] The limits are indexed for inflation.

Tax treatment of and limits on contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an Archer MSA high deductible health plan under present law, as adjusted for inflation. For 2005, the amount of the maximum deductible under an Archer MSA high deductible health plan is $2,650 in the case of self-only coverage and $5,250 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. Qualified medical expenses generally are defined as under section 213(d). Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums for Medicare, other than premiums for Medigap policies. Such qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under section 213. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income are also subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Archer MSAs

Like HSAs, an Archer MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. Archer

MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for MSA purposes, a high deductible health plan is a health plan with (a) an annual deductible of at least $1,750 and no more than $2,650 in the case of self-only coverage and at least $3,500 and no more than $5,250 in the case of family coverage and (b) maximum out-of pocket expenses of no more than $3,500 in the case of self-only coverage and no more than $6,450 in the case of family coverage;[62] (3) higher contributions may be made to HSAs, and (4) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

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

Description of Proposal

The proposal provides a refundable tax credit for health insurance ("health insurance tax credit" or "HITC") purchased by individuals who are under age 65 and do not participate in a public or employer-provided health plan. The maximum annual amount of the credit is 90 percent of premiums, up to a maximum premium of $1,111 per adult and $556 per child (for up to two children). These dollar amounts are indexed in accordance with the medical care component of the Consumer Price Index based on all-urban consumers. Thus, the maximum annual credit (prior to any indexing of the premium limits) is $1,000 per adult and $500 per child (up to two children), for a total possible maximum credit of $3,000 per tax return.

The 90 percent credit rate is phased-down for higher income taxpayers. Individual taxpayers filing a single return with no dependents and modified adjusted gross income of $15,000 or less are eligible for the maximum credit rate of 90 percent. The credit percentage for individuals filing a single return with no dependents is phased-down ratably from 90 percent to 50 percent for modified adjusted gross income between $15,000 and $20,000, and phased-out completely at modified adjusted gross income of $30,000.

Other taxpayers with modified adjusted gross income up to $25,000 are eligible for the maximum credit rate of 90 percent. The credit percentage is phased-out ratably for modified adjusted gross income between $25,000 and $40,000 if the policy covers only one adult, and for modified adjusted gross income between $25,000 and $60,000 if the policy (or policies) covers more than one adult.

Taxpayers may not claim the present-law HCTC and this credit for the same coverage period. In addition, taxpayers may not claim the HITC for the same period as they claim the

[62] The deductible and out-of-pocket expenses dollar amounts are for 2005. These amounts are indexed for inflation in $50 increments.

above-the-line deduction for high deductible health plan premiums included in the President's fiscal year 2005 budget proposal.

If the health insurance purchased by an individual qualifies as a high deductible health plan under the HSA rules, the individual may elect to have 30 percent of the credit contributed in a special HSA (or in a special account in the individual's HSA). The rules applicable to HSAs would apply to the special HSA (or special account), except that withdrawals that exceed qualified medical expenses would be subject to a tax equal to 100 percent of the amount withdrawn. The 30-percent credit would be counted toward the HSA contribution limit.

The credit can be claimed on the individual's tax return or on an advanced basis, as part of the premium payment process, by reducing the premium amount paid to the insurer. After implementation of the advanced payment option, the benefit of the credit will be available at the time that the individual purchases health insurance, rather than later when the individual files his or her tax return the following year. Health insurers will be reimbursed by the Department of the Treasury for the amount of the credit. Eligibility for the advanced credit option is based on the individual's prior year return and there is no reconciliation on the current year return.

Policies eligible for the credit have to meet certain requirements, including coverage for high medical expenses.[63] Qualifying health insurance can be purchased through the non-group insurance market, private purchasing groups, State-sponsored insurance purchase pools, and State high-risk pools.[64]

At the option of States, after December 31, 2006, the credit can be used by certain individuals not otherwise eligible for public health insurance programs to buy into privately contracted State-sponsored purchasing groups (such as Medicaid or SCHIP purchasing pools for private insurance or State government employee programs for States in which Medicaid or SCHIP does not contract with private plans). States can provide additional contributions to individuals who purchase insurance through such purchasing groups. The maximum State contribution is $2,000 per adult (for up to two adults) for individuals with incomes up to 133 percent of the poverty level. The maximum State contribution is phased-down ratably, reaching $500 per adult at 200 percent of the poverty level. Individuals with income above 200 percent of the poverty level are not eligible for a State contribution. States are not allowed to offer any other explicit or implicit cross subsidies.

Effective date.–The credit is effective for taxable years beginning after December 31, 2005. The advanced payment option is to be available beginning July 1, 2007.

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[63] The proposal does not include details regarding the requirements policies must satisfy.

[64] A separate part of the budget provides for $4 billion in Federal grants to States to establish purchasing pools.

Analysis

Policy issues

In general

The proposal is intended to provide an incentive to uninsured individuals to purchase health insurance by providing assistance in paying premiums. Proponents of the proposal argue that the proposal will enable low-income individuals to purchase health insurance, thereby reducing the number of uninsured individuals.

Opponents of the credit argue that it is not sufficient to make insurance affordable for many individuals and thus would not be utilized by many uninsured. For example, the credit may not improve the opportunity for coverage in the individual market for the elderly and individuals with chronic health problems if coverage is too expensive, even with the credit. In addition, opponents of the credit question whether the amount of the credit will be sufficient to allow many low-income individuals, regardless of age or health status, to purchase adequate health insurance coverage. They argue that the credit is too low to allow individuals to purchase a policy other than a very minimal policy, and that those most likely to benefit from the credit will be insurers. Proponents counter that the credit level is sufficient, and that individuals who purchase insurance as a result of the credit will be better off than they would be without insurance.

Some opponents are also concerned about the focus of the credit on insurance purchased in the individual market. They believe the individual market does not presently offer sufficient protections to purchasers, and that any credit for the purchase of coverage in the individual market should only be adopted if accompanied by market reforms that ensure such protection.

The proposal addresses some of the present-law differences in tax treatment between employer-subsidized health insurance and insurance purchased by individuals. Critics of the proposal argue that providing a credit for the purchase of health insurance undermines the current employment-based health insurance system by encouraging healthier individuals who can obtain less expensive coverage in the individual market to leave the employee pool, thus increasing the cost of insurance for the employees remaining in the pool. Further, some argue that the existence of the tax credit could cause some employers to not offer health benefits for their employees. This could cause the insurance market to turn into a predominantly individual market, which could result in an increase in the cost of health coverage for some individuals.

Others argue that the design of the credit will not cause employees to leave employers' plans, as the credit is targeted to low-income individuals who are less likely to have employer-provided health insurance. Additionally, the subsidy rate is phased out as income increases and there is a cap on the premium eligible for the subsidy.

Because of the limit on the number of children per family eligible for the credit, families with more than two children will receive a smaller benefit under the proposal. For example, a married couple with two children could be eligible for a credit up to $3,000, while a single parent with three children could be eligible for a maximum credit of only $2,000.

Some argue that the objective of the proposal to increase health insurance would be better served under a direct spending program, especially because the credit is refundable and does not require that the individual pay tax. Those opponents to the credit argue that expanding public programs would be a better alternative because such expansion would make health insurance coverage more affordable and accessible. On the other hand, a spending program may provide less individual choice of health insurance options.

Advanced payment mechanism

The advanced payment feature of the credit raises numerous issues. The main argument in favor of providing the credit on an advanced basis is that many of the intended recipients might not be able to purchase insurance without the advanced credit. Because advancing the credit merely changes the timing of payment and does not reduce the cost of insurance (except for the time value of money), this argument is best understood not as making the insurance affordable, as is often stated, but rather in making it available to those who would not otherwise be able to arrange the financing to pay for the insurance in advance of receiving the credit. Given the target population of the credit, it might reasonably be argued that for many potential users of the credit, other financing mechanisms, such as credit cards, loans from relatives or friends, personal savings, etc., would not be available, or would not be used even if available, and the best way to encourage individuals to buy insurance would be to provide the credit in advance, at the time of purchase of the insurance.

Some argue that the mechanism for delivering the credit on an advanced basis is not effective. For example, basing eligibility on the prior year's income raises issues. Using prior year information may make the advanced payment option easier to administer, however, using the prior year data and not requiring reconciliation means that the credit will in some cases not reach those intended to receive it. For example, individuals can have low income in the current year when they need assistance in purchasing health insurance, but prior year income that is too high to qualify for the advanced payment of the credit. Such individuals are not eligible to receive the credit on the advanced basis and in many cases, because of their decreased income, will remain uninsured.

Some argue that the advanced payment mechanism of the proposal is flawed because an individual could receive the credit as an advanced payment based on the prior year's income, even though ineligible for the credit because of the current year's income. Because there is no reconciliation required on the current year return, such individual is not required to repay the amount of the advanced payment of the credit to the government. For example, a recently graduated student could have current year income of over $100,000, but prior year income of less than $15,000 because the individual was in school on a full-time basis. Such individual could be entitled to the $1,000 advanced payment of the credit even though the current year income exceeds the credit income limitation. Thus, using prior year income may result in inefficiency regarding delivery of the credit to the intended target population.

Using current year data or requiring reconciliation would reduce this problem. Using current year data could, however, create other issues, such as complicating the mechanics of the advanced payment system and enforcement issues. For example, it may be difficult in some

cases to collect the additional tax owed by people who erroneously claimed the advance credit. Experience with the earned income credit shows that this could be the case.

The fact that the tax credit is refundable could lead to fraud and abuse by taxpayers, as it may be difficult for the IRS to successfully enforce against taxpayers claiming the credit even though ineligible. Similar to the earned income credit, it would be difficult for the IRS to timely detect fraudulent refunds issued to taxpayers.

Complexity issues

Creating a new tax credit adds complexity to the Code. By providing additional options to individuals, the proposal may increase complexity because individuals will have to determine which option is best for them. A new tax credit will increase complexity in IRS forms and instructions, by requiring new lines on several tax forms and additional information in instructions regarding the tax credit. The new credit would also require IRS programming modifications. Taxpayers covered by high-deductibles plans that are not part of a public or employer-provided plan will need to calculate their tax liability twice to determine whether the proposed credit exceeds the value of the alternative premium deduction (as provided in the President's fiscal year 2006 budget proposal).

Additionally, the credit adds new phase-outs to the numerous existing phase-outs in the Code, which increases complexity.[65]

The advanced payment aspect of the credit also adds additional complexity to the Code. Taxpayers would have to use different income amounts to calculate the credit depending whether the credit is claimed on an advanced basis or on the current year tax return. The proposal may also increase complexity for insurance companies by adding administrative burdens with respect to the advanced payment of the credit. Health insurers would be required to provide information statements to taxpayers receiving the credit on an advanced payment basis and to the IRS, including the policy number, the policy premium, and that the policy meets the requirements for a qualified policy.

Prior Action

Substantially similar proposals were included in the President's fiscal year 2002, 2003, 2004, and 2005 budget proposals.

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[65] For a discussion of issues relating to income phase-outs, see Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Volume II at 79.

2. Provide an above-the-line deduction for certain high deductible insurance premiums

Present Law

In general

Present law contains a number of provisions dealing with the Federal tax treatment of health expenses and health insurance coverage. The tax treatment of health insurance expenses depends on whether a taxpayer is covered under a health plan paid for by an employer, whether an individual has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold. The tax benefits available with respect to health care expenses also depends on the type of coverage.

Exclusion for employer-provided coverage

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[66] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care.[67] If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan is also excludable from an employee's gross income and wages.[68] A cafeteria plan allows employees to choose between cash and certain nontaxable benefits, including health coverage. Through the use of a cafeteria plan, employees can pay for health coverage on a salary reduction basis.

Present law provides for two general employer-provided arrangements that can be used to pay for or reimburse medical expenses of employees on a tax-favored basis: flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs"). While these arrangements provide similar tax benefits (i.e., the amounts paid under the arrangements for medical care are excludable from gross income and wages for employment tax purposes), they are subject to different rules. A main distinguishing feature between the two arrangements is that while FSAs are generally part of a cafeteria plan and contributions to FSAs are made on a salary reduction basis, HRAs cannot be part of a cafeteria plan and contributions cannot be made on a

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[66] Secs. 106, 3121(a)(2), and 3306(b)(2).

[67] Sec. 105. In the case of a self-insured medical reimbursement arrangement, the exclusion applies to highly compensated employees only if certain nondiscrimination rules are satisfied. Sec. 105(h). Medical care is defined as under section 213(d) and generally includes amounts paid for qualified long-term care insurance and services.

[68] Secs. 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

salary-reduction basis.[69] In addition, amounts in an HRA may be used to purchase insurance as well as to reimburse expenses not covered by insurance, while amounts in an FSA cannot be used for insurance, but are used to pay for expenses not coverage by insurance.

Deduction for health insurance expenses of self-employed individuals

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership)[70] are entitled to deduct 100 percent of the amount paid for health insurance for themselves and their spouse and dependents for income tax purposes.[71]

Itemized deduction for medical expenses

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year for health insurance (to the extent not reimbursed by insurance or otherwise) for the taxpayer, the taxpayer's spouse, and dependents, only to the extent that the taxpayer's total medical expenses, including health insurance premiums, exceeds 7.5 percent of the taxpayer's adjusted gross income.[72]

Health care tax credit

Under the Trade Adjustment Assistance Reform Act of 2002,[73] certain individuals are eligible for the health coverage tax credit ("HCTC"). The HCTC is a refundable tax credit for 65 percent of the cost of qualified health coverage paid by an eligible individual. In general, eligible individuals are individuals receiving a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 and receiving pension benefits from the Pension Benefit Guaranty Corporation. The credit is available for "qualified health insurance," which includes certain employer-based insurance, certain State-based insurance, and in some cases, insurance purchased in the individual market. The credit is available on an advance basis through a program established by the Secretary.

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[69] Notice 2002-45, 2002-28 I.R.B. 93 (July 15, 2002); Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (July 15, 2002).

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

[71] Sec. 162(l). The deduction does not apply for self-employment tax (SECA) purposes.

[72] Sec. 213. The adjusted gross income percentage is 10 percent for purposes of the alternative minimum tax. Sec. 56(b)(1)(B).

[73] Pub. L. No. 107-210, secs. 201(a), 202 and 203 (2002).

Health savings accounts

In general

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003[74] allows individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) to establish a health savings account ("HSA"). An HSA is a tax-exempt trust or custodial account. In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses.

Eligible individuals

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan and which provides coverage for any benefit which is covered under the high deductible health plan. Individuals entitled to benefits under Medicare are not eligible to make contributions to an HSA. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return. An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage.[75]

A high deductible health plan is a health plan that has a deductible for 2005 that is at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit that is no more than $5,100 in the case of self-only coverage and $12,000 in the case of family coverage.[76] A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

Tax treatment of and limits on contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made

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[74] Pub. L. No. 108-173 (2003).

[75] Permitted insurance is: (1) 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; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

[76] The limits are indexed for inflation.

through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an Archer MSA high deductible health plan under present law, as adjusted for inflation. For 2005, the amount of the maximum deductible under an Archer MSA high deductible health plan is $2,650 in the case of self-only coverage and $5,250 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. Qualified medical expenses generally are defined as under section 213(d). Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums for Medicare, other than premiums for Medigap policies. Such qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under section 213. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income are also subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Archer MSAs

Like HSAs, an Archer MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an

Archer MSA; (2) for MSA purposes, a high deductible health plan is a health plan with (a) an annual deductible of at least $1,750 and no more than $2,650 in the case of self-only coverage and at least $3,500 and no more than $5,250 in the case of family coverage and (b) maximum out-of pocket expenses of no more than $3,500 in the case of self-only coverage and no more than $6,450 in the case of family coverage;[77] (4) the contribution limits for HSAs are higher than for MSAs; and (4) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

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

Description of Proposal

The proposal provides an above-the-line deduction for high deductible health insurance premiums for individuals who contribute to an HSA. As under the present-law rules relating to HSA eligibility, an individual does not qualify for the deduction if the individual is covered by any health plan other than the high deductible plan for which the deduction is claimed, except for certain permitted coverage. The deduction is only allowed for insurance purchased in the individual insurance market and is not allowed for individuals covered by employer plans or public plans. Additionally, the deduction is not allowed to an individual claiming the present-law HCTC or the proposed refundable tax credit for the purchase of health insurance included in the President's fiscal year 2006 budget proposal.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2005.

Analysis

Policy issues

The proposal is intended to provide an incentive for individuals to purchase high deductible health plans in connection with the use of HSAs. Allowing a deduction for premiums of high deductible health plans provides a subsidy for the purchase of such plans, thus making them more affordable. The proposal raises both health policy issues and tax policy issues.

Proponents believe that the use of high deductible health plans promotes responsible health policy. Proponents argue that the use of high deductible health plans (together with HSAs) will encourage cost consciousness and result in better decision-making with respect to health care expenses because such plans make individuals more aware of their health care expenses.

[77] The deductible and out-of-pocket expenses dollar amounts are for 2005. These amounts are indexed for inflation in $50 increments.

Critics argue that it is inappropriate to favor high deductible health plans. Critics argue that providing a preference for the purchase of high deductible health insurance purchased in the individual market undermines the current group-based health insurance system by encouraging healthier individuals who can obtain less expensive coverage in the individual market to leave the employee pool, thus increasing the cost of insurance for the employees remaining in the pool. Critics also argue that any health cost reductions hoped for due to the use of high deductible health plans are undermined by the availability of HSAs, which allow for the payment of the first dollar of health expenses on a tax-favored basis.

Critics have concerns with favoring any insurance purchased in the individual market. Some argue that favoring plans purchased in the individual market and excluding employer plans may cause some employers to not offer health benefits for their employees if they feel that significant tax incentives exist in the individual market. Critics argue that this could cause the insurance market to turn into a predominantly individual market, which could result in an increase in the cost of health coverage for some individuals. Critics argue that individuals who are unable to obtain coverage in the individual market will be greatly disadvantaged by the proposal. Critics are also concerned about the focus of the deduction on insurance purchased in the individual market because they believe the individual market does not presently offer sufficient protections to purchasers, and that any tax incentive for the purchase of coverage in the individual market should only be adopted if accompanied by reforms (e.g., guaranteed issue).

Proponents also argue that the proposal will reduce the number of uninsured individuals. Many uninsured individuals may purchase high deductible health plans given the tax advantages of HSAs and the deduction under the proposal. Others argue that because the proposal is limited to a certain type of plan, it may have a minimal effect on reducing the number of uninsured. Some may argue that those who are uninsured because they cannot afford coverage still may not have sufficient resources to afford a high deductible plan even on a tax-subsidized basis. Other younger healthier uninsured individuals who can afford health insurance may choose to continue to remain uninsured even with the tax incentive.

Some criticize the proposal as providing a targeted subsidy for one type of insurance product for which there has been a weak market, rather than directly addressing the social policy issue of the rising cost of health care and number of uninsured individuals. On the other hand, some point out that Congress has already provided subsidies to high deductible health plans through the tax law (i.e., HSAs) to encourage people to use such plans and save for health expenses, and that this proposal is consistent with the policy already expressed by Congress.

Proponents argue that the proposal will reduce the inequities under present law regarding the tax treatment of health insurance expenses. Proponents argue that providing a deduction for high deductible health plans will level the playing field for those who are not self-employed or do not have employer-provided coverage. While the proposal addresses some of the present-law differences in the tax treatment between employer-subsidized health insurance and insurance purchased by individuals, critics argue that it is not appropriate for a tax subsidy for the purchase of insurance to be limited to one particular type of plan. Critics argue that limiting the subsidy to high deductible health plans will further contribute to the inequitable tax treatment of health expenses and may actually increase inequities by providing, in connection with HSAs, a very generous subsidy for one particular type of plan.

Some argue that the present-law differences in the tax treatment between employer-subsidized health insurance and insurance purchased by individuals could be more equitably addressed by limiting the exclusion for employer-provided health coverage. Others question whether an exclusion for employer-provided health expenses should exist, as such preference leads to a tax system which is not neutral with respect to similar expenses. Some argue that a tax preference should exist only to the extent extraordinary medical expenses affect an individual's ability to pay and that this is already sufficiently addressed with the present-law itemized deduction (to the extent of 7.5 percent of adjusted gross income) for medical expenses.

Even if one agrees that high deductible health plans are preferable from a health policy perspective and should be tax-favored, some argue that inequities will result because the proposal is narrowly targeted. For example, because the proposal is limited to insurance purchased in the individual market, an individual participating in a group high-deductible plan could not qualify for the deduction even if the employee pays 100 percent of the cost of coverage.

While the proposal provides that the deduction is not allowed for individuals covered by employer plans, it is unclear what specifically constitutes an employer plan. For example, an employee could have a high deductible health plan purchased in the individual market, a portion of the cost of which is paid by the employer. It is unclear whether such plan would qualify for the deduction.

Complexity issues

Conditioning the deduction on making a contribution to an HSA adds complexity to the proposal compared to providing a deduction without such a requirement. In addition, the requirement is easily satisfied, raising questions as to whether the additional complexity serves any policy function. For example, an individual could contribute as little as $1 to an HSA and be eligible for the deduction.

By providing additional options to individuals, the proposal may increase transactional complexity because individuals will have to determine which option is best for them. Individuals eligible for the proposed refundable tax credit for health insurance will have to determine which option is best for them because such individuals are not eligible for both the credit and the deduction. Employees will also have to determine whether it is better to remain in employer plans or to purchase a policy in the individual market.

Creating a new tax deduction will necessitate a new line on the Form 1040 and additional information in instructions regarding the deduction. The new deduction may also require IRS programming modifications.

Prior Action

A similar proposal was included in the President's fiscal year 2005 budget proposal.

3. Provide a refundable tax credit for contributions of small employers to employee health savings accounts ("HSAs")

Present Law

In general

Present law contains a number of provisions dealing with the Federal tax treatment of health expenses and health insurance coverage. The tax treatment of health insurance expenses of an individual depends on whether the individual is covered under a health plan paid for by an employer, has self-employment income, or itemizes deductions and has medical expenses that exceed a certain threshold. The tax benefits available with respect to health care expenses also depends on the type of coverage.

Exclusion for employer-provided coverage

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[78] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care.[79] If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan is also excludable from an employee's gross income and wages.[80] A cafeteria plan allows employees to choose between cash and certain nontaxable benefits, including health coverage. Through the use of a cafeteria plan, employees can pay for health coverage on a salary reduction basis.

Present law provides for two general employer-provided arrangements that can be used to pay for or reimburse medical expenses of employees on a tax-favored basis: flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs"). While these arrangements provide similar tax benefits (i.e., the amounts paid under the arrangements for medical care are excludable from gross income and wages for employment tax purposes), they are subject to different rules. A main distinguishing feature between the two arrangements is that while FSAs are generally part of a cafeteria plan and contributions to FSAs are made on a salary reduction basis, HRAs cannot be part of a cafeteria plan and contributions cannot be made on a

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[78] Secs. 106, 3121(a)(2), and 3306(b)(2).

[79] Sec. 105. In the case of a self-insured medical reimbursement arrangement, the exclusion applies to highly compensated employees only if certain nondiscrimination rules are satisfied. Sec. 105(h). Medical care is defined as under section 213(d) and generally includes amounts paid for qualified long-term care insurance and services.

[80] Secs. 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

salary-reduction basis.[81] In addition, amounts in an HRA may be used to purchase insurance as well as to reimburse expenses not covered by insurance, while amounts in an FSA cannot be used for insurance, but are used to pay for expenses not coverage by insurance.

Employer contributions for accident or health coverage, including contributions to an HRA and contributions made through a cafeteria plan, are generally deductible to the employer as a compensation expense.

Deduction for health insurance expenses of self-employed individuals

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership)[82] are entitled to deduct 100 percent of the amount paid for health insurance for themselves and their spouse and dependents for income tax purposes.[83]

Itemized deduction for medical expenses

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year for health insurance (to the extent not reimbursed by insurance or otherwise) for the taxpayer, the taxpayer's spouse, and dependents, only to the extent that the taxpayer's total medical expenses, including health insurance premiums, exceeds 7.5 percent of the taxpayer's adjusted gross income.[84]

Health care tax credit

Under the Trade Adjustment Assistance Reform Act of 2002,[85] certain individuals are eligible for the health coverage tax credit ("HCTC"). The HCTC is a refundable tax credit for 65 percent of the cost of qualified health coverage paid by an eligible individual. In general, eligible individuals are individuals receiving a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 and receiving pension benefits from the Pension

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[81] Notice 2002-45, 2002-28 I.R.B. 93 (July 15, 2002); Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (July 15, 2002).

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

[83] Sec. 162(l). The deduction does not apply for self-employment tax (SECA) purposes.

[84] Sec. 213. The adjusted gross income percentage is 10 percent for purposes of the alternative minimum tax. Sec. 56(b)(1)(B).

[85] Pub. L. No. 107-210, secs. 201(a), 202 and 203 (2002).

Benefit Guaranty Corporation. The credit is available for "qualified health insurance," which includes certain employer-based insurance, certain State-based insurance, and in some cases, insurance purchased in the individual market. The credit is available on an advance basis through a program established by the Secretary.

Health savings accounts

In general

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003[86] allows individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) to establish a health savings account ("HSA"). An HSA is a tax-exempt trust or custodial account. In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses.

Eligible individuals

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan and which provides coverage for any benefit which is covered under the high deductible health plan. Individuals entitled to benefits under Medicare are not eligible to make contributions to an HSA. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return. An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage.[87]

A high deductible health plan is a health plan that has a deductible, for 2005, that is at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit that is no more than $5,100 in the case of self-only coverage and $12,000 in the case of family coverage.[88] A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

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[86] Pub. L. No. 108-173.

[87] Permitted insurance is: (1) 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; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

[88] The limits are indexed for inflation.

Tax treatment of and limits on contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an Archer MSA high deductible health plan under present law, as adjusted for inflation. For 2005, the amount of the maximum deductible under an Archer MSA high deductible health plan is $2,650 in the case of self-only coverage and $5,250 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

Employer contributions to an HSA are generally deductible by the employer as compensation expense.

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. Qualified medical expenses generally are defined as under section 213(d). Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums for Medicare, other than premiums for Medigap policies. Such qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under section 213. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income are also subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Archer MSAs

Like HSAs, an Archer MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for MSA purposes, a high deductible health plan is a health plan with (a) an annual deductible of at least $1,750 and no more than $2,650 in the case of self-only coverage and at least $3,500 and no more than $5,250 in the case of family coverage and (b) maximum out-of pocket expenses of no more than $3,500 in the case of self-only coverage and no more than $6,450 in the case of family coverage;[89] (3) the contribution limits for HSAs are higher than that for MSAs, and (4) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

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

Description of Proposal

The proposal provides a refundable tax credit to small employers for contributions made to the HSAs of employees. A small employer is defined as an employer that normally employs fewer than 100 employees on a typical business day. Governmental and not-for-profit employers do not qualify for the credit.

The credit applies to 100 percent of contributions made by the small employer, up to a maximum annual credit amount of $200 for contributions on behalf of an individual with single coverage and $500 for an individual with family coverage. In order to receive the credit, the employer is required to maintain a high deductible health plan (as defined under the HSA rules) accessible to all employees. The employer is not required to make contributions toward employee premiums for the health plan.

The tax credit is not includible in income and is not subject to the general business tax credit rules. The employer is not entitled to a deduction for the amount reimbursed by the credit.

The amount of the employer contribution to an HSA for which the credit is claimed must be maintained in a special HSA or within a special account in the employee's HSA. The rules applicable to HSAs apply to the special HSA (or special account), except that withdrawals that exceed qualified medical expenses are subject to a tax of 100 percent of the amount of the withdrawal.

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[89] The deductible and out-of-pocket expenses dollar amounts are for 2005. These amounts are indexed for inflation in $50 increments.

Sole proprietors, partners, and S corporation shareholders are eligible for the credit if their business is a small employer and the business provides the same HSA contributions to all employees who have the same type of coverage or has no employees. Self-employed individuals are not entitled to a deduction for the amount reimbursed by the credit. The credit is pro-rated if eligible coverage is held for less than 12 months.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2005.

Analysis

The stated intent of the proposal is to encourage small employers to offer coverage and contribute toward the health care of their employees. The proposal is aimed at HSAs, because of their link to high deductible plans, which the proponents of the proposal believe may encourage more cost consciousness with respect to health care.

The proposal's emphasis on HSAs and high deductible policies raises issues similar to those raised by other aspects of the budget proposal (i.e., the above-the-line deduction for the cost of high deductible health plans and the health insurance tax credit) as to whether it is appropriate to favor such insurance over other types of insurance. As discussed further above, while some argue that such insurance is preferable to an individual having no insurance and may result in greater cost awareness, others question whether such insurance is appropriate and question whether it provides adequate protections.

Although the proposal is framed in terms of a credit for small employers, the ultimate effect of the proposal is on employees of such employers. Particularly given the refundable nature of the credit, the employer may be viewed as a conduit for delivery of a subsidy to employees of small employers.

While employer-provided health coverage is generally lower among employees of small firms compared to employees of larger firms, some argue that a proposal providing a subsidy for employees of small firms is not well targeted. They argue that it would be more appropriate to provide subsidies for health care costs based on income (or wealth) or other factors that may better reflect need.

To the extent that employees of small employers are considered an appropriate target group, the proposal does not provide the subsidy to all employees of small employers. In particular, by denying a similar subsidy for employees of small not-for-profit or governmental entities, the proposal arguably discriminates against individuals who work for such employers.

The proposal does not provide a subsidy for the purchase of health insurance itself. It may be argued that making insurance more affordable is addressed by other aspects of the budget proposals, specifically the proposed health insurance tax credit and the above-the-line deduction for high deductible plan premiums. However, this proposal may force some employees to choose between this credit and the above-the-line deduction or health insurance tax credit. This is because the deduction and health insurance credit are not available with respect to group coverage. However, in order to claim the small employer credit, the employee must purchase the health insurance offered by the small employer. For many employees, taking the value of the

above-the-line deduction or the health insurance credit will be more valuable than the credit for HSA contributions received through a small employer.

Prior Action

No prior action.

4. Modify the refundable credit for health insurance costs of eligible individuals

Present Law

Refundable health insurance credit: in general

Under the Trade Act of 2002,[90] in the case of taxpayers who are eligible individuals, a refundable tax credit is provided for 65 percent of the taxpayer's expenses for qualified health insurance of the taxpayer and qualifying family members for each eligible coverage month beginning in the taxable year. The credit is commonly referred to as the health coverage tax credit ("HCTC"). The credit is available only with respect to amounts paid by the taxpayer.

Qualifying family members are the taxpayer's spouse and any dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency exemption. Any individual who has other specified coverage is not a qualifying family member.

Persons eligible for the credit

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if, as of the first day of the month, the taxpayer (1) is an eligible individual, (2) is covered by qualified health insurance, (3) does not have other specified coverage, and (4) is not imprisoned under Federal, State, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements. An eligible month must begin after November 4, 2002.[91]

An eligible individual is an individual who is (1) an eligible TAA recipient, (2) an eligible alternative TAA recipient, and (3) an eligible PBGC pension recipient.

An individual is an eligible TAA recipient during any month if the individual (1) is receiving for any day of such month a trade adjustment allowance[92] or who would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment

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[90] Pub. L. No. 107-210 (2002).

[91] This date is 90 days after the date of enactment of the Trade Act of 2002, which was August 6, 2002.

[92] Part I of subchapter B, or subchapter D, of chapter 2 of title II of the Trade Act of 1974.

benefits before being eligible to receive an allowance and (2) with respect to such allowance, is covered under a certification issued under subchapter A or D of chapter 2 of title II of the Trade Act of 1974. An individual is treated as an eligible TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is an eligible alternative TAA recipient during any month if the individual (1) is a worker described in section 246(a)(3)(B) of the Trade Act of 1974 who is participating in the program established under section 246(a)(1) of such Act, and (2) is receiving a benefit for such month under section 246(a)(2) of such Act. An individual is treated as an eligible alternative TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is a PBGC pension recipient for any month if he or she (1) is age 55 or over as of the first day of the month, and (2) is receiving a benefit any portion of which is paid by the Pension Benefit Guaranty Corporation (the "PBGC"). The IRS has interpreted the definition of PBGC pension recipient to also include certain alternative recipients and recipients who have received certain lump-sum payments on or after August 6, 2002.

An otherwise eligible taxpayer is not eligible for the credit for a month if, as of the first day of the month the individual has other specified coverage. Other specified coverage is (1) coverage under any insurance which constitutes medical care (except for insurance substantially all of the coverage of which is for excepted benefits)[93] maintained by an employer (or former employer) if at least 50 percent of the cost of the coverage is paid by an employer[94] (or former employer) of the individual or his or her spouse or (2) coverage under certain governmental health programs.[95] A rule aggregating plans of the same employer applies in

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[93] Excepted benefits are: (1) coverage only for accident or disability income or any combination thereof; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) worker's compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; (7) coverage for on-site medical clinics; (8) other insurance coverage similar to the coverages in (1)-(7) specified in regulations under which benefits for medical care are secondary or incidental to other insurance benefits; (9) limited scope dental or vision benefits; (10) benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof; and (11) other benefits similar to those in (9) and (10) as specified in regulations; (12) coverage only for a specified disease or illness; (13) hospital indemnity or other fixed indemnity insurance; and (14) Medicare supplemental insurance.

[94] An amount is considered paid by the employer if it is excludable from income. Thus, for example, amounts paid for health coverage on a salary reduction basis under an employer plan are considered paid by the employer.

[95] Specifically, an individual is not eligible for the credit if, as of the first day of the month, the individual is (1) entitled to benefits under Medicare Part A, enrolled in Medicare Part B, or enrolled in Medicaid or SCHIP, (2) enrolled in a health benefits plan under the Federal Employees Health Benefit Plan, or (3) entitled to receive benefits under chapter 55 of title 10 of

determining whether the employer pays at least 50 percent of the cost of coverage. A person is not an eligible individual if he or she may be claimed as a dependent on another person's tax return. A special rule applies with respect to alternative TAA recipients. For eligible alternative TAA recipients, an individual has other specified coverage if the individual is (1) eligible for coverage under any qualified health insurance (other than coverage under a COBRA continuation provision, State-based continuation coverage, or coverage through certain State arrangements) under which at least 50 percent of the cost of coverage is paid or incurred by an employer of the taxpayer or the taxpayer's spouse or (2) covered under any such qualified health insurance under which any portion of the cost of coverage is paid or incurred by an employer of the taxpayer or the taxpayer's spouse.

Qualified health insurance

Qualified health insurance eligible for the credit is: (1) COBRA continuation coverage; (2) State-based continuation coverage provided by the State under a State law that requires such coverage; (3) coverage offered through a qualified State high risk pool; (4) coverage under a health insurance program offered to State employees or a comparable program; (5) coverage through an arrangement entered into by a State and a group health plan, an issuer of health insurance coverage, an administrator, or an employer; (6) coverage offered through a State arrangement with a private sector health care coverage purchasing pool; (7) coverage under a State-operated health plan that does not receive any Federal financial participation; (8) coverage under a group health plan that is available through the employment of the eligible individual's spouse; and (9) coverage under individual health insurance if the eligible individual was covered under individual health insurance during the entire 30-day period that ends on the date the individual became separated from the employment which qualified the individual for the TAA allowance, the benefit for an eligible alternative TAA recipient, or a pension benefit from the PBGC, whichever applies.[96]

Qualified health insurance does not include any State-based coverage (i.e., coverage described in (2)-(8) in the preceding paragraph), unless the State has elected to have such coverage treated as qualified health insurance and such coverage meets certain requirements.[97] Such State coverage must provide that each qualifying individual is guaranteed enrollment if the individual pays the premium for enrollment or provides a qualified health insurance costs eligibility certificate and pays the remainder of the premium. In addition, the State-based coverage cannot impose any pre-existing condition limitation with respect to qualifying

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the United States Code (relating to military personnel). An individual is not considered to be enrolled in Medicaid solely by reason of receiving immunizations.

[96] For this purpose, "individual health insurance" means any insurance which constitutes medical care offered to individuals other than in connection with a group health plan. Such term does not include Federal- or State-based health insurance coverage.

[97] For guidance on how a State elects a health program to be qualified health insurance for purposes of the credit, see Rev. Proc. 2004-12, 2004-9 I.R.B. 1.

individuals. State-based coverage cannot require a qualifying individual to pay a premium or contribution that is greater than the premium or contribution for a similarly situated individual who is not a qualified individual. Finally, benefits under the State-based coverage must be the same as (or substantially similar to) benefits provided to similarly situated individuals who are not qualifying individuals. A qualifying individual is an eligible individual who seeks to enroll in the State-based coverage and who has aggregate periods of creditable coverage[98] of three months or longer, does not have other specified coverage, and who is not imprisoned. A qualifying individual also includes qualified family members of such an eligible individual.

Qualified health insurance does not include coverage under a flexible spending or similar arrangement or any insurance if substantially all of the coverage is of excepted benefits.

Other rules

Amounts taken into account in determining the credit may not be taken into account in determining the amount allowable under the itemized deduction for medical expenses or the deduction for health insurance expenses of self-employed individuals. Amounts distributed from a medical savings account or health savings account are not eligible for the credit. The amount of the credit available through filing a tax return is reduced by any credit received on an advance basis. Married taxpayers filing separate returns are eligible for the credit; however, if both spouses are eligible individuals and the spouses file a separate return, then the spouse of the taxpayer is not a qualifying family member.

The Secretary of the Treasury is authorized to prescribe such regulations and other guidance as may be necessary or appropriate to carry out the provision.

Advance payment of refundable health insurance credit; reporting requirements

The credit is payable on an advance basis (i.e., prior to the filing of the taxpayer's return). The disclosure of return information of certified individuals to providers of health insurance information is permitted to the extent necessary to carry out the advance payment mechanism. The Code does not specify the items of return information that are to be disclosed, nor does it provide for the disclosure of such information to contractors of the health insurance providers authorized to receive such information. Advance payment of the credit has been available since August 1, 2003. To the extent that disclosures to persons not authorized under the statute are necessary a consent mechanism has been employed. The signature block of the registration form for the credit states "By signing, I also agree to allow the IRS to share my eligibility status and payment information with my health plan administrator." Applicants are required to give such consent in applying for the credit.

Any person who receives payments during a calendar year for qualified health insurance and claims a reimbursement for an advance credit amount is required to file an information

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[98] Creditable coverage is determined under the Health Care Portability and Accountability Act (Code sec. 9801(c)).

return with respect to each individual from whom such payments were received or for whom such a reimbursement is claimed.

Description of Proposal

The President's proposal modifies the health coverage tax credit in several ways.

The proposal modifies the requirement that State-based coverage not impose pre-existing condition limitations. The proposal allows State-based coverage to impose a modified pre-existing condition restriction similar to the rules under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"). The pre-existing condition exclusion can be imposed for a period of up to 12 months, but must be reduced by the length of the eligible individual's creditable coverage, as of the date the individual applies for the State-based coverage. The exclusion must relate to a condition (whether physical or mental), regardless of the cause of the condition, for which medical advice, diagnosis, care, or treatment was recommended or received within the 6-month period ending on the date the individual seeks to enroll in the coverage. The exclusion cannot be an exclusion described in Code section 9801(d) (relating to exclusions not applicable to certain newborns, certain adopted children, or pregnancy).

The proposal also allows spouses of eligible individuals to claim the credit even after the eligible individual becomes entitled to Medicare, provided that the spouse (1) is at least age 55; (2) is covered by qualified health insurance, the premium of which is paid by the taxpayer; (3) does not have other specific coverage; and (4) is not imprisoned under Federal, State, or local authority.

The proposal also makes other changes to the credit. Under the proposal, individuals who elect to receive one-time lump sum payments from the PBGC and certain alternative PBGC payees are eligible for the credit.

The proposal provides that the Commonwealths of Puerto Rico and the Northern Mariana Islands, American Samoa, Guam, and the U.S. Virgin islands are deemed to be States for purposes of the State-based coverage rules.

In addition, the proposal allows disclosure of certain information necessary to carry out the advance payment program to contractors of providers of health insurance and provides that providers of health insurance include employers and administrators of health plans.

Additionally, under the proposal, State continuation coverage provided under State law automatically qualifies as qualified health insurance, as Federally-mandated COBRA continuation coverage, without having to meet the requirements relating to State-based qualified coverage.

The proposal also changes the definition of other specified coverage for eligible alternative TAA recipients by removing the special rule that applies only to alternative TAA recipients.

Effective date.–The proposal modifying the requirement that there be no imposition of a pre-existing condition exclusion is effective for eligible individuals applying for coverage after

December 31, 2005. The proposal relating to spouses of HCTC-eligible individuals is effective for taxable years beginning after December 31, 2005. The remaining proposals are effective as if included in the Trade Act of 2002.

Analysis

In general

The HCTC was enacted to assist certain individuals in paying for qualified health insurance. The various aspects of the proposal will make the credit available to more individuals. Some aspects of the proposal may be considered clarifications of present law based on current IRS administrative positions.

Pre-existing condition exclusion

The proposal modifies the requirement for State-based coverage that there be no imposition of a pre-existing condition exclusion. Proponents argue that this change is necessary to allow States not currently offering qualified health insurance to be able to offer qualified insurance. Many States argue that it is difficult to implement qualifying State-based coverage with the present-law requirement that there be no imposition of a pre-existing condition exclusion. Others argue that modification of the no imposition of preexisting conditions exclusion eliminates an important consumer protection afforded under State-based coverage. Proponents counter that the modified requirement under the proposal, coupled with the other consumer protections, including guaranteed issue, provides sufficient protections, especially in the case of States where the alternative would be no qualifying State-based coverage. Critics argue that if State-based coverage must satisfy the present-law requirement, States will eventually produce a qualifying option which will allow its citizens access to the credit while maintaining the protection. They argue that since the vast majority of States have been able to produce a qualifying option under the present-law requirements, the few States that have not offered qualified insurance should not be afforded a less stringent rule.

Spouses of eligible individuals entitled to Medicare

The proposal allows spouses of eligible individuals to claim the credit when the eligible individual becomes entitled to Medicare, provided that the spouse (1) is at least age 55; (2) is covered by qualified health insurance, the premium of which is paid by the taxpayer; (3) does not have other specified coverage; and (4) is not imprisoned under Federal, State or local authority. Under present law, once an otherwise eligible individual is entitled to benefits under Medicare, the spouse of the individual is no longer eligible for the credit, even if the spouse if not entitled to benefits under Medicare.

Not allowing the credit to the spouses of Medicare-eligible individuals can result in many spouses dropping coverage once the eligible individual becomes entitled to Medicare and becoming uninsured. The proposal is intended to prevent such result.

Eligible individuals

Under the proposal, individuals who elect to receive one-time lump-sum payments from the PBGC are eligible for the credit. While the IRS has interpreted the credit as applying to individuals who receive a one-time lump sum from the PBGC and certain alternative PBGC payees, clarifying statutorily that such individuals are eligible individuals will simplify administration of the credit. Many believe that individuals who receive a one-time lump-sum pension payment in lieu of an annuity should not be ineligible for the credit simply because they are not receiving payments on a monthly basis. In general, lump-sum payments are only received if the value of the benefit is $5,000 or less. Given the relatively small amount of the payments, most agree that requiring participants to take an annuity in order to qualify for the credit is not desirable.

The proposal also provides that certain alternative PBGC payees are eligible for the credit. In general, alternative PBGC payees include alternative payees under a qualified domestic relations order and beneficiaries of deceased employees who are receiving payments from the PBGC. Many believe that fairness requires that such individuals should be treated as eligible PBGC pension recipients.

Certain commonwealths and possessions

The proposal providing that the Commonwealths of Puerto Rico and the Northern Mariana Islands, American Samoa, Guam, and the U.S. Virgin islands are deemed to be States for purposes of the State-based coverage rules allows such possessions and commonwealths to elect a State-based coverage option, which will allow residents greater access to the credit. Under present law, if an individual meets the definition of an eligible individual, residents of the possessions and commonwealths may be eligible for the credit; however, because the possession or commonwealth in which they live is not able to offer qualified health insurance, such individuals are generally unable to access the credit. The proposal would allow certain possessions and commonwealths to offer qualified health insurance. Proponents argue that since the credit is targeted to specific groups of individuals (i.e., individuals receiving benefits under TAA or from the PBGC), residents of such commonwealths and possessions who are eligible individuals should not be denied the credit because their residence cannot offer a qualified State-based option.

While residents of the possessions and commonwealths are U.S. citizens,[99] special tax rules apply. Some question whether it is appropriate to provide a refundable health tax credit to residents of possessions and commonwealths who may never pay U.S. tax. Certain other tax credits are not available to such individuals. For example, the earned income credit and child tax credit are generally not available to such residents.[100]

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[99] There is an exception for those on American Samoa who are U.S. nationals.

[100] The refundable child tax credit is available to residents of the possessions if the individual has three of more qualifying children and pays FICA or SECA taxes.

Expanded disclosure

The proposal allows disclosure of certain information necessary to carry out the advance payment program to contractors of providers of health insurance and provides that providers of health insurance include employers and administrators of health plans. Proponents argue that modifying the disclosure provisions is necessary to make the advance payment program administrable. The proposal would eliminate uncertainty regarding disclosures permitted for purposes of the credit. Under present law, disclosure is permitted only to providers of health insurance. Proponents argue that in order to facilitate operation of the advance payment program it is necessary that disclosure of certain information be permitted to employers and administrators of health plans and to contractors of providers of health insurance.

Since advance payment of the credit became available August 1, 2003, a consent mechanism has been used to the extent that disclosures not technically permitted under the statute are necessary. Proponents argue that clarifying the disclosure provisions statutorily would simplify administration of the credit.

Many believe that taxpayer information should be highly safeguarded and that any expansion of the disclosure rules should be as narrow as possible. For example, some argue that, given the breadth of the present-law statute, the use of contractors could expand significantly the risk of unauthorized disclosure of sensitive information. Some argue that if present law were narrowed to the discrete items relating to the health program, such risk would be diminished. Others argue that items such as taxpayer identification numbers and health insurance membership are commonly obtained by the health plans and are not as sensitive as other return information.

State continuation coverage

The proposal providing that State continuation coverage automatically qualifies as qualified health insurance results in removing certain State-based coverage requirements from State continuation coverage. These requirements include guaranteed issue, no imposition of preexisting conditions (as modified by this proposal), nondiscriminatory premiums and similar benefits. Proponents argue that many States lack qualified State-based coverage and allowing State continuation coverage to automatically qualify would allow more individuals access to the credit. Proponents also argue that since State continuation coverage is similar to COBRA continuation, which is not subject to the State-based coverage requirements, it is appropriate to waive such requirements for State continuation coverage. Proponents argue that it is inappropriate for the State-based coverage requirements to apply to State continuation coverage as certain rules applicable to State continuation coverage are inconsistent with such requirements.

Critics argue that it is extremely important for individuals to have the protections relating to guaranteed issue, preexisting conditions, nondiscriminatory premiums and similar benefits. They argue that if the applicable requirements are waived, individuals will lose valuable rights with respect to their health care. In addition, opponents argue that if State continuation coverage automatically meets the requirements for qualified health insurance, States will be less inclined to work towards producing a qualifying option that includes the otherwise applicable

requirements. Critics of the proposal argue that if all State-based coverage must satisfy the requirements, States will eventually produce a qualifying option which will allow its citizens access to the credit while retaining the important consumer protections. This change is viewed by critics as a substantive change from what was originally intended, rather than a clarification of present law.

Other specified coverage of alternative TAA recipients

The proposal also changes the definition of other specified coverage for eligible alternative TAA recipients by removing the special rule that applies only to alternative TAA recipients, which results in applying the same definition of other specified coverage to all eligible individuals. Under the proposal, for all eligible individuals, specified coverage would include coverage under a health plan maintained by an employer (except for insurance substantially all of which is for excepted benefits) than pays at least 50 percent of the cost of coverage and certain governmental health programs. Proponents argue that the proposal would reduce complexity in administering the credit, as similar rules would apply to all individuals. Some argue that despite the complexity in having different rules, the special rule for alternative TAA recipients should be retained.

Prior Action

Several components of the proposal were included in the President's fiscal year 2005 budget proposal.

5. Expand human clinical trial expenses qualifying for the orphan drug tax credit

Present Law

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

Description of Proposal

The proposal expands qualifying expenses to include those expenses related to human clinical testing paid or incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder, if certain conditions are met. Under the proposal, qualifying expenses include those expenses paid or incurred after the date on which the taxpayer files an application with the FDA for designation as a potential treatment for a rare disease or disorder if the drug receives FDS designation before the due date (including extensions) for filing the tax return for the taxable year in which the application was filed with the FDA. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

Effective date.–The provision is effective for qualified expenditures incurred after December 31, 2004.

Analysis

Approval for human clinical testing and designation as a potential treatment for a rare disease or disorder require separate reviews within the FDA. As a result, in some cases, a taxpayer may be permitted to begin human clinical testing prior to a drug being designated as a potential treatment for a rare disease or disorder. If the taxpayer delays human clinical testing in order to obtain the benefits of the orphan drug tax credit, which currently may be claimed only for expenses incurred after the drug is designated as a potential treatment for a rare disease or disorder, valuable time will have been lost and Congress's original intent in enacting the orphan drug tax credit will have been partially thwarted.

For those cases where the process of filing an application and receiving designation as a potential treatment for a rare disease or disorder occurs sufficiently expeditiously to fall entirely within the taxpayer's taxable year plus permitted filing extension, the proposal removes the potential financial benefit from delaying clinical testing. While such an outcome may well describe most applications, in some cases, particularly for applications filed near the close of a taxpayer's taxable year, there may be some uncertainty that designation will be made in a timely manner. In such a case, the taxpayer is in the same position as present law and may choose to delay filing the appropriate application until the beginning of his next taxable year.

The FDA is required to approve drugs for human clinical testing. Such approval creates a unique starting point from which human clinical testing expenses can be measured. An alternative proposal would be to expand qualifying expenses to include those expenses paid or incurred after the date on which the taxpayer files an application with FDA for designation of the drug as a potential treatment for a rare disease or disorder, regardless of whether the designation is approved during the taxable year in which the application is filed. Such an alternative proposal would provide more certainty to the taxpayer regarding clinical expenses eligible for the credit. However, unlike the current proposal, such an alternative may create the additional taxpayer burden of requiring the taxpayer to file an amended return to claim credit for qualifying costs related to expenses incurred in a taxable year prior to designation.

The staff of the Joint Committee on Taxation recommended a change similar to the current proposal as part of its 2001 simplification study.[101]

Prior Action

An identical proposal was part of the President's fiscal year 2005 budget proposal. A similar proposal was part of the President's fiscal year 2004 budget proposal.

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[101] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(b) of the Internal Revenue Code of 1986, Vol. II* (JCS-3-01), April 2001, at 310.

C. Provisions Relating to Charitable Giving

1. Permit tax-free withdrawals from individual retirement arrangements for charitable contributions

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply, and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to an organization described in section 170(c), including charities and Federal, State, and local governmental entities. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[102]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[103] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[104]

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[102] Secs. 170(b) and (e).

[103] Sec. 170(f)(8).

[104] Sec. 6115.

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base; (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base; and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes an overall limitation on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2005 is $145,950 ($72,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases out the overall limitation on itemized deductions for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[105] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[106] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

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[105] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[106] Sec. 170(f)(2).

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[107] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Traditional IRAs are subject to minimum distribution rules, under which distributions from the IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-½.

Traditional and Roth IRAs are subject to post-death minimum distribution rules that require that distributions upon the death of the IRA owner must begin by a certain time.

Description of Proposal

The proposal provides an exclusion from gross income for otherwise taxable IRA withdrawals from a traditional or a Roth IRA for distributions to a qualified charitable organization. The exclusion does not apply to indirect gifts to a charity through a split interest entity, such as a charitable remainder trust, a pooled income fund, or a charitable gift annuity. The exclusion is available for distributions made on or after the date the IRA owner attains

[107] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

age 65 and applies only to the extent the individual does not receive any benefit in exchange for the transfer. Amounts transferred directly from the IRA to the qualified charitable organization are treated as a distribution for purposes of the minimum distribution rules applicable to IRAs. No charitable contribution deduction is allowed with respect to any amount that is excluded from income under this provision. Amounts transferred from the IRA to the qualified organization that would not be taxable if transferred directly to the individual, such as a qualified distribution from a Roth IRA or the return of nondeductible contributions from a traditional IRA, are subject to the present law charitable contribution deduction rules.

Effective date.–The proposal is effective for distributions made after the date of enactment.

Analysis

Policy issues

In general, the proposal is intended to enable IRA owners to give a portion of their IRA assets to charity without being subject to the charitable contribution percentage limitations or the overall limitation on itemized deductions. Present law requires an IRA owner to take the IRA distribution into income, give the money to a qualified charity, and then claim a deduction for the gift. However, the deduction is subject to the percentage limitations of section 170 and to the overall limit on itemized deductions. The proposal will avoid these limitations and therefore might encourage additional charitable giving by increasing the tax benefit of the donation for those who would not be able to fully deduct the donation by reason of the present-law limitations. However, some argue that the proposal merely avoids present-law limitations on charitable contributions that will be made in any event and will not encourage additional giving.

Further, some question the appropriateness of limiting the tax benefits of the provision to IRA owners. That is, if the limits on charitable deductions are determined to be undesirable, they should be removed for all taxpayers, not only those that are able to make charitable contributions through an IRA. In addition, the proposal will alter present law and give IRA owners a tax benefit for charitable contributions even if they do not itemize deductions. For example, under present law, a taxpayer who takes the standard deduction cannot claim a charitable contribution deduction; however, under the proposal, a taxpayer can both claim the standard deduction and benefit from the exclusion. It might be beneficial for taxpayers who itemize their deductions but have a significant amount of charitable deductions to make their charitable contributions through the IRA and then claim the standard deduction.

In addition, some argue that the proposal inappropriately will encourage IRA owners to use retirement monies for nonretirement purposes (by making such use easier and providing greater tax benefits in some cases). To the extent that the proposal will spur additional gifts by circumventing the percentage limitations, IRA owners may spend more of their retirement money for nonretirement purposes than under present law. Some also argue that, in the early years of retirement, an individual might not accurately assess his or her long-term retirement income needs. For example, the individual might not make adequate provision for health care or long-term care costs later in life. Some therefore argue that IRA distributions to charity should be permitted, if at all, only after age 70.

Complexity issues

The proposal adds complexity to the tax law by creating an additional set of rules applicable to charitable donations. Taxpayers who own IRAs and make such donations will need to review two sets of rules in order to determine which applies to them and which is the most advantageous. The proposal may increase the complexity of making charitable contributions because individuals who are able and wish to take advantage of the tax benefits provided by the proposal will need to make the donation through the IRA rather than directly. The proposal also may increase complexity in tax planning as the proposal might make it beneficial for some taxpayers to take the standard deduction and make all charitable contributions through their IRAs.

In some cases, taxpayers may need to apply both sets of rules to a single contribution from an IRA. This will occur if the IRA distribution includes both taxable amounts (which would be subject to the rules in the proposal) and nontaxable amounts (which would be subject to the present-law rules). As discussed above, the effect of the proposal is to eliminate certain present-law limits on charitable deductions for IRA owners. A simpler approach is to eliminate such limits with respect to all charitable contributions. Providing a single rule for charitable contributions would make the charitable deduction rules easier to understand for all taxpayers making such contributions.

Prior Action

A similar proposal was included in the President's fiscal years 2004 and 2005 budget proposals. The President's fiscal years 2002 and 2003 budget proposals included a similar proposal, except that the exclusion would have applied to distributions made on or after the date the IRA owner attained age 59-½.

In the 108th Congress, S. 476, the "CARE Act of 2003," as agreed to by the Senate on April 9, 2003, included a similar provision that would have provided an exclusion for an otherwise taxable distribution from an IRA that was made (1) directly to a charitable organization on or after the date the IRA owner attains age 70-½, or (2) to a split-interest entity on or after the date the IRA owner attains age 59-½. H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a similar provision, except the H.R. 7 provision would have applied to distributions made directly to a charitable organization or to a split-interest entity only on or after the date the IRA owner reaches age 70-½ and the exclusion would not have applied to distributions from SIMPLE IRAs or simplified employee pensions.

2. Expand and increase the enhanced charitable deduction for contributions of food inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) the taxpayer's basis in the contributed property plus one-half of the property's

appreciated value (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[108]

To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (other than a private nonoperating foundation), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To claim the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[109]

Description of Proposal

Under the proposal, the enhanced deduction for donations of food inventory is increased to the lesser of (1) fair market value, or (2) two times the taxpayer's basis in the contributed inventory. In addition, any taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim an enhanced deduction for donations of food inventory. The deduction for donations by S corporations and noncorporate taxpayers is limited to 10 percent of the net income from the associated trade or business. The proposal provides a special rule that would permit certain taxpayers with a zero or low basis in the food donation (e.g., taxpayers that use the cash method of accounting for purchases and sales, and taxpayers that are not required to capitalize indirect costs) to assume a basis equal to 25 percent of the food's fair market value. In such cases, the allowable charitable deduction will equal 50 percent of the food's fair market value. The enhanced deduction for food inventory will be available only for food that qualifies as "apparently wholesome food" (defined as food that is intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions). The proposal provides that the fair market value of apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market would be determined by taking into account the price at which the same or substantially the same food items (taking into account both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

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[108] Sec. 170(e)(3).

[109] *Lucky Stores Inc. v. Commissioner,* 105 T.C. 420 (1995).

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Policy issues

In the absence of the enhanced deduction of present law, if the taxpayer were to dispose of excess inventory by dumping the excess food in a garbage dumpster, the taxpayer generally could claim the purchase price of the inventory (the taxpayer's basis in the property) as an expense against his or her gross income. In the absence of the enhanced deduction of present law, if the taxpayer were to donate the excess food inventory to a charitable organization that maintains a food bank, the taxpayer generally would be able to claim a charitable deduction equal to the taxpayer's basis in the food inventory (subject to certain limits on charitable contributions). Viewed from the taxpayer's profit motive, the taxpayer would be indifferent between donating the food or dumping the food in a garbage dumpster. If the taxpayer must incur cost to deliver the food to the charity that maintains the food bank, the taxpayer would not find it in his or her financial interest to donate the excess food inventory to the food bank. The enhanced deduction creates an incentive for the taxpayer to contribute excess food inventory to charitable organizations that provide hunger relief.

In general, the proposal is intended to give businesses greater incentive to contribute food to those in need. By increasing the value of the enhanced deduction, up to the fair market value of the food, and by clarifying the definition of fair market value, the proposal is intended to encourage more businesses to donate more food to charitable organizations that provide hunger relief. However, some argue that if the intended policy is to support food programs for the needy, it would be more direct and efficient to provide a direct government subsidy instead of making a tax expenditure through the tax system, which may result in abuse and cannot be monitored under the annual budgetary process. On the other hand, proponents of the proposal likely would argue that a government program would be less effective in identifying the needy and overseeing delivery of the food than would the proposal.[110]

More specifically, critics argue that the definition of fair market value under the proposal is too generous because it may permit taxpayers to claim as fair market value the full retail price of food that was no longer fresh when donated. If so, taxpayers might be better off contributing the food to charity than by selling the food in the ordinary course of their business. For example, assume a taxpayer whose income is taxed at the highest corporate income tax rate of 35 percent has purchased an avocado for $0.75. The taxpayer previously could have sold the avocado for $1.35, but now could only sell the avocado for $0.30. If the taxpayer sold the avocado for $0.30, the taxpayer would incur a loss of $0.45 ($0.75 basis minus $0.30 sales revenue) on the sale. Because the loss on the sale of the avocado reduces the taxpayer's taxable income, the taxpayer's

[110] See generally Louis Alan Talley, "Charitable Contributions of Food Inventory: Proposals for Change Under the 'Community Solutions Act of 2001,'" Congressional Research Service Report for Congress (August 23, 2001).

tax liability would decline by approximately \$0.16 (\$0.45 multiplied by 35 percent), so the net loss from the sale in terms of after-tax income would be \$0.29. If, alternatively, the taxpayer had donated the avocado to the local food bank, and under the proposal were allowed to claim a deduction for the previous fair market value of \$1.35, the taxpayer's taxable income would be reduced by \$1.35 resulting in a reduction in tax liability of approximately \$0.47 (\$1.35 multiplied by 35 percent). However, the taxpayer originally purchased the avocado for \$0.75 and, as the avocado is donated, this expense cannot be deducted as a cost of goods sold. By donating the avocado, the taxpayer's net loss on the avocado is \$0.28 (the \$0.47 in income tax reduction minus the cost of acquiring the avocado, \$0.75). Under the proposal, the taxpayer loses less on the avocado by donating the avocado to charity than by selling the avocado.

This possible outcome is a result of permitting a deduction for a value that the taxpayer may not be able to achieve in the market. Whether sold or donated, the taxpayer incurred a cost to acquire the good. When a good is donated, it creates "revenue" for the taxpayer by reducing his or her taxes otherwise due. When the value deducted exceeds the revenue potential of an actual sale, the tax savings from the charitable deduction can exceed the sales revenue from a sale. While such an outcome is possible, in practice it may not be the norm. In part because the proposal limits the enhanced deduction to the lesser of the measure of fair market value or twice the taxpayer's basis, it can only be more profitable to donate food than to sell food if the taxpayer would otherwise be selling the food to be donated at a loss. In general, it depends upon the amount by which the deduction claimed exceeds the taxpayer's basis in the food relative to the extent of the loss the taxpayer would incur from a sale.[111]

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[111] In general, it is never more profitable to donate food than to sell food unless the taxpayer is permitted to deduct a value other than the current fair market value of the food. To see this:

- let Y denote the taxpayer's pre-tax income from all other business activity;
- let B denote the taxpayer's acquisition cost (basis) of the item to be donated;
- let α represent the percentage by which the permitted deduction exceeds the taxpayer's basis, that is αB equals the value of the deduction permitted;
- let β equal the current market value as a percentage of the taxpayer's basis in the item, that is the revenue that could be attained from sale is βB;

and let t denote the taxpayer's marginal tax rate.

Further assume that $\beta < 1 < \alpha$, that is, at the current market value the taxpayer would be selling at a loss, but previously the taxpayer could sell at a profit.

The taxpayer's after-tax income from sale of the item is $(Y + \beta B - B)(1-t)$.

Under the proposal, the taxpayer's after-tax income from contribution of the item is $Y - B - t(Y - \alpha B)$. For the case in which the permitted deduction would exceed twice the

In addition, to the extent the proposal would subsidize food disposal, companies producing food may take less care in managing their inventories and might have less incentive to sell aging food by lowering prices, knowing that doing so might also reduce the value of an eventual deduction.[112] Critics also argue that the proposal would in effect provide a deduction for the value of services, which are not otherwise deductible, because in some cases, services are built into the fair market value of food.

Complexity issues

The proposal has elements that may both add to and reduce complexity of the charitable contribution deduction rules. Under present law, the general rule is that charitable gifts of inventory provide the donor with a deduction in the amount of the donor's basis in the inventory. The Code currently contains several exceptions: a special rule for contributions of inventory that is used by the donee solely for the care of the ill, the needy, or infants, a special rule for contributions of scientific property used for research, and a special rule for contributions of computer technology and equipment used for educational purposes. Each special rule has distinct requirements. The proposal would add another special rule, with its own distinct requirements, thereby increasing the complexity of an already complex section of the Code. The proposal also could decrease complexity, however, because it would provide a definition of fair market value. Under current law, valuation of food inventory has been a disputed issue between

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taxpayer's basis, the taxpayer's after-tax income from contribution of the item is $Y - B - t(Y - 2B)$.

It is more profitable to donate the item than to sell it when the following inequality is satisfied.

(1) $(Y + \beta B - B)(1-t) < Y - B - t(Y - \alpha B)$.

This inequality reduces to:

(2) $\beta/(\beta + (\alpha-1)) < t$.

Whether it is more profitable to donate food than to sell food depends upon the extent to which the food would be sold at a loss (β) relative to the extent of the loss plus the extent to which the permitted deduction exceeds the taxpayer's basis (α-1), compared to the taxpayer's marginal tax rate. Because under present law, the marginal tax rate is 0.35, equation (2) identifies conditions on the extent of loss and the permitted deduction that could create a situation where a charitable contribution produces a smaller loss than would a market sale, such as the example in the text. In the case where the taxpayer's deduction would be limited to twice basis, it is possible to show that for a marginal tax rate of 35 percent, the current market value of the item to be donated must be less than 53.8 percent of the taxpayer's basis in the item, that is, $\beta < 0.538$.

[112] See Martin A. Sullivan, "Economic Analysis: Can Bush Fight Hunger With a Tax Break?," *Tax Notes*, vol. 94, February 11, 2002, at 671.

taxpayers and the IRS and a cause of uncertainty for taxpayers when claiming the deduction. Another interpretative issue could arise in deciding whether the contributed food is "substantially" the same as other food items sold by the taxpayer for purposes of determining fair market value of the food.

Taxpayers who contribute food inventory must consider multiple factors to ensure that they deduct the permitted amount (and no more than the permitted amount) with respect to contributed food. Taxpayers who are required to maintain inventories for their food purchases must compare the fair market value of the contributed food with the basis of the food (and twice the basis of the food), and coordinate the resulting contribution deduction with the determination of cost of goods sold.[113] Taxpayers who are not required to maintain inventories for their food purchases generally will have a zero or low basis in the contributed food, but are permitted to use a deemed basis rule that provides such taxpayers a contribution deduction equal to 50 percent of the food's fair market value. Taxpayers who are not required to maintain inventories need not coordinate cost of goods sold deductions or inventory adjustments with contribution deductions, and are not required to recapture the previously expensed costs associated with the contributed food.

Prior Action

The President's fiscal year 2003, 2004 and 2005 budget proposals contained a similar proposal.

3. Reform excise tax based on investment income of private foundations

Present Law

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts, also are subject to an excise tax, under section 4940(b).

Net investment income generally includes interest, dividends, rents, royalties, and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[114] equals or exceeds the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment

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

[114] Sec. 4942(g).

income of the foundation for the taxable year.[115] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements.[116]

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation was tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code. Exempt operating foundations are exempt from the section 4940 tax.[117]

Nonoperating private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[118]

Description of Proposal

The proposal replaces the two rates of excise tax on private foundations with a single rate of tax and sets the rate at one percent. Thus, under the proposal, a tax-exempt private foundation is subject to tax on one percent of its net investment income. A taxable private foundation is subject to tax on the excess of the sum of the one percent excise tax and the amount of the unrelated business income tax (both calculated as if the foundation were tax-exempt) over the income tax imposed on the foundation. The proposal repeals the special one-percent excise tax for private foundations that exceed their historical level of qualifying distributions.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

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[115] Sec. 4940(e).

[116] Sec. 4942.

[117] Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

[118] Sec. 4942(d)(2).

Analysis

The proposal has the effect of increasing the required minimum charitable payout for private foundations that pay the excise tax at the two-percent rate.[119] This may result in increased charitable distributions for private foundations that pay only the minimum in charitable distributions under present law. For example, if a foundation is subject to the two-percent excise tax on net investment income, the foundation reduces the amount of required charitable distributions by the amount of excise tax paid. Because the proposal decreases the amount of excise tax paid on net investment income for such foundations, the proposal increases such foundations' required minimum amount of charitable distributions by an amount equal to one percent of the foundation's net investment income. Thus, the proposal results in an increase of charitable distributions in the case of foundations paying the two-percent rate and distributing no greater than the required minimum under present law. Foundations paying the two-percent rate that exceed the required minimum under present law generally would not have to increase their charitable distributions as a result of the proposal. Although the required minimum amount of charitable distributions would increase for such foundations, such foundations already make distributions exceeding the minimum and so generally would not have to increase charitable distributions as a result of the proposal (except to the extent that the increase in the required minimum amount was greater than the excess of a private foundation's charitable distributions over the required minimum amount of present law). However, a reduction in the excise tax rate from 2 percent to 1 percent may result in increased charitable distributions to the extent that a foundation decides to pay out the amount that otherwise would be paid in tax for charitable purposes.

The proposal also eliminates the present-law two-tier tax structure. Some have suggested that the two-tier excise tax is an incentive for foundations to increase the amounts they distribute to charities.[120] Critics of the present-law two-tier excise tax have criticized the efficiency of the excise tax as an incentive to increase payout rates. First, critics note, the reduction in excise tax depends only upon an increase in the foundation's rate of distributions to charities, not on the size of the increase in the rate of distributions. Thus, a large increase in distributions is rewarded by the same reduction in excise tax rate as is a small increase in distributions. There is no extra incentive to make a substantial increase in distributions rather than a quite modest increase in distributions.

In addition, critics assert that, under a number of circumstances, the present-law two-tier excise tax can create a disincentive for foundations to increase charitable distributions

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[119] Operating foundations are not subject to the minimum charitable payout rules. Sec. 4942(a)(1).

[120] In general, foundations that make only the minimum amount of charitable distributions and seek to minimize total payouts have no incentive to decrease their rate of excise tax because such a decrease would result in an increase in the required minimum amount of charitable distributions, thus making no difference to the total payout of the private foundation.

substantially.[121] In order to take advantage of the one-percent excise tax rate, a private foundation must increase its rate of charitable distributions in the current year above that which prevailed in the preceding five years. Whether the present-law two-tier excise tax creates an incentive or disincentive to increased payout rates depends, in part, on whether the foundation currently is subject to the one-percent tax rate or the two-percent tax rate. Because modest increases in payout rates qualify a foundation for the one-percent tax rate, some analysts suggest that a foundation may be able to manage its distributions actively so that the foundation qualifies for the one-percent tax rate without substantially increasing its payout rate.[122] For a foundation subject to the one-percent rate in the current year, an increased payout in any year becomes part of the computation to determine eligibility for the one-percent rate in future years. Thus, under the present-law formula, the foundation can trigger the two-percent excise tax rate by increasing the payout amount in a particular year because increased payouts make it more difficult for the foundation to qualify for the one-percent rate in subsequent years, and it increases the possibility that the foundation will become subject to the two-percent tax rate. Consequently, over time, the one-percent rate provides a disincentive for increasing charitable distributions.

On the other hand, for a foundation currently subject to the one-percent excise tax rate and also making charitable distributions at a rate above the minimum required amount, the present-law two-tier excise tax can create a disincentive for foundations to reduce their payout rate. A reduction in payout rate in the future would reduce the foundation's five-year moving average, thereby increasing the likelihood the foundation's net investment income is taxed at the two-percent rate, rather than the one-percent rate.[123]

For a foundation currently subject to the excise tax at the two-percent rate, an increase in payout may qualify the foundation for the one-percent excise tax rate. If the increase does qualify the foundation for the one-percent rate, and the foundation maintains the same payout for the subsequent four years, the foundation generally will be eligible for the one-percent tax rate in each of the five years. Hence the reduced tax rate can create an incentive to increase payout rates. However, even in the case of a two-percent excise tax paying foundation, the present-law two-tier excise tax can create a disincentive for a foundation to increase charitable distributions substantially in any one year compared to a strategy of slowly increasing payouts over several years. For example, consider a foundation which has had a payout rate of 5.0 percent for several years. Suppose the foundation is considering increasing its payout rate. Consider two possible

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[121] See C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," *American Journal of Tax Policy*, 12, Fall 1995, at 399-447.

[122] For example, if over a 10-year period the foundation increased its payout rate from the minimum 5.00 percent to 5.01 percent, to 5.02 percent, up to 5.10 percent, the foundation generally would qualify for the one-percent excise tax rate throughout the 10-year period.

[123] Whether a reduction in payout rate causes the foundation to pay the two-percent tax rate depends upon the specific pattern of its payout rate in the preceding five years and the magnitude of the decrease in the current year.

strategies: increase the payout rate to 8.0 percent in the current year followed by rates of 5.5 percent thereafter; or gradually increase the payout rate by increments of one-tenth of one percent annually for five years. While a substantial increase in any one year may qualify the foundation for the one-percent tax rate, subsequent year payout rates of 5.5 percent would fail to qualify the foundation for the one- percent tax rate.[124] Thus, under the first option, the foundation would pay the one-percent tax rate for one year and be a two-percent tax rate payor subsequently. Under the second option, the foundation would qualify for the one-percent rate in each year. However, total payouts are greater under the first option.

In summary, the incentive effects of the present-law two-tier excise tax depend upon the situation in which the foundation finds itself in the current year. In 1999, 42 percent of foundations were one-percent tax rate payors and 58 percent were two-percent rate payors. Among large foundations (assets of $50 million or greater) 58 percent were one-percent rate payors and 42 percent were two-percent rate payors.[125] A number of analysts suggest the optimal tax strategy for a private foundation is to choose a target rate of disbursement, maintain that rate in all years, and never fall below the target in any year.[126]

Critics of the present-law excise tax structure observe that the median payout rate of large nonoperating private foundations (foundations with total assets of $50 million or more) was 5.1 or 5.0 percent in each year from 1991 through 1995 and was 5.0 percent in 1999.[127] The median payout rates for foundations with assets between $10 million and $50 million declined annually from 5.4 percent in 1990 to 5.1 percent in 1995 and 1999. Similarly, the median payout rates for foundations with assets between $100,000 and $1 million declined from 6.7 percent in 1990 to 5.5 percent in 1995 and 5.4 percent in 1999.[128] Critics of the present-law excise tax structure argue that these data suggest that the excise tax structure is not encouraging any noticeable increase in payout rates.

The proposal reduces complexity for private foundations by replacing the two-tier tax on net investment income with a one-tier tax. Under the proposal, private foundations do not have to allocate resources to figuring which tier of the tax would be applicable or to planning the optimum payout rate. The proposal also would make compliance easier for private foundations,

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[124] In this example, after having paid out 8.0 percent, the five-year average payout for the first year in which the foundation pays out 5.5 percent would be 5.6 percent.

[125] See Figure E in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002 at 143.

[126] Steuerle and Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," at 438.

[127] See Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 at 73; Figure I in Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999" at 148.

[128] *Id*.

as they would not have to compute a five-year average of charitable distributions on the information return they file each year.

Prior Action

The President's fiscal year 2003, 2004, and 2005 budget proposals included a similar proposal.

The President's fiscal year 2001 budget proposal included a similar proposal, but would have reduced the rate of tax to 1.25 percent.

H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a similar proposal.

4. Modify tax on unrelated business taxable income of charitable remainder trusts

Present Law

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[129]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred; (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and (4) corpus.[130]

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[129] Sec. 664(d).

[130] Sec. 664(b).

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[131]

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year.

Description of Proposal

The proposal imposes a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust. This replaces the present-law rule that removes the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Under the proposal, the tax is treated as paid from corpus. The unrelated business taxable income is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004, regardless of when the trust was created.

Analysis

The proposal is intended to produce a better result than present law for trusts that have only small or inadvertent amounts of unrelated business taxable income. The present-law rule that any amount of unrelated business taxable income results in loss of tax-exemption for the year discourages trusts from making investments that might generate insignificant (or inadvertent) unrelated business taxable income. A loss of exemption could be particularly punitive in a year in which a trust sells, for example, the assets that originally funded the trust and does not distribute the proceeds. The proposal avoids this result by requiring a trust to pay the amount of the unrelated business taxable income as an excise tax but does not require the trust to pay tax on all of its other income for the year. In addition, the proposal is helpful to trusts that receive unrelated business taxable income as a result of a change in the status of the entity in which trust assets are invested. However, the proposal also may enable trusts to choose to make certain investments that have small amounts of unrelated business income that are and some may argue should be discouraged by present law. For example, investments in rental property may generate a small amount of unrelated business taxable income from fees for services provided to tenants. Such investments may be unattractive for charitable remainder trusts under present law because the unrelated income causes the trust to lose exemption. Under

[131] Treas. Reg. sec. 1.664-1(d)(4).

the proposal, however, a rental property owner might have an incentive to contribute the rental property to a charitable remainder trust (of which the owner was beneficiary) to shelter the rental income from tax (to the extent the rental income exceeds the unitrust amount or annuity payment). Some argue that charitable remainder trusts should not be encouraged to make such investments.

The proposal also is intended to be a more effective deterrent than present law to prevent charitable remainder trusts from investing in assets that generate large amounts of unrelated business taxable income. Although present law requires that a charitable remainder trust become a taxable trust for a year in which the trust has unrelated business taxable income, a charitable remainder trust nevertheless may invest in assets that produce significant unrelated business income but pay tax only on the trust's undistributed income. This is because, as a taxable trust, the trust may take a deduction for distributions of income that are taxable to the beneficiaries. (To the extent the trust pays tax, trust assets are depleted to the detriment of the charitable beneficiary.) Thus, proponents argue that the proposal better deters trusts from making investments that generate significant unrelated business taxable income because the 100 percent excise tax would be prohibitive. On the other hand, some question whether such a deterrent is the right policy in cases where a trustee determines that investment in assets that produce unrelated business taxable income will increase the (after tax) rate of return to the trust (and thus inure to the benefit of the charitable remainderman).

The proposal provides that unrelated business taxable income is treated as ordinary income to the trust and taxes are paid from corpus. Thus, the proposal treats the trust beneficiary the same as under present law, that is, distributions of the unrelated business income are taxed as ordinary income to the beneficiary. As a result, the proposed rule in effect taxes the unrelated business income twice, once as an excise tax (at a 100-percent rate), and again when distributed. (Double taxation presently exists to the extent that the trust's income from all sources exceeds the amount distributed to the beneficiary during a year in which the trust is not exempt from income tax.) Proponents of the proposal would argue that double taxation is not a concern because the excise tax is intended as a penalty for incurring unrelated business income. Proponents also would argue that although an alternative approach, for example, to tax the unrelated business income as an excise tax but not again when distributed, would avoid any perceived double taxation of the unrelated income, such an alternative would have undesired effects. Proponents would argue that if unrelated income is not taxed when distributed, a trust might have a strong incentive to invest in assets that produce unrelated income in order to convey a benefit to the beneficiary that is not available under present law (capital gain income or tax-free return of corpus instead of ordinary income). In addition, proponents would note, the charitable remainderman's interest would be diminished to the extent a trust invested significantly in unrelated business income producing assets.

The proposal simplifies the operation of charitable remainder trusts in that a trust with a small amount of unrelated business taxable income does not lose its tax exemption and therefore does not need to file income tax returns and compute its taxable income as if it were a taxable trust. This has the effect of not discouraging trustees to make investments that might entail having a small amount of unrelated business taxable income.

Prior Action

A similar proposal was included in the President's fiscal year 2003, 2004, and 2005 budget proposals.

H.R. 7, the "Community Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a similar provision, except that unrelated business income would be excluded from the determination of (1) the value of a charitable remainder unitrust's assets, (2) the amount of charitable remainder unitrust income for purposes of determining the unitrust's required distributions, and (3) the effect on the income character of any distributions to beneficiaries by a charitable remainder annuity trust or charitable remainder unitrust.

S. 476, The "CARE Act of 2003," as agreed to by the Senate on April 9, 2003, contained a similar proposal.

5. Modify the basis adjustment to stock of S corporations contributing appreciated property

Present Law

Under present law, a shareholder of an S corporation takes into account, in determining its own income tax liability, its pro rata share of any charitable contribution of money or other property made by the corporation.[132] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[133]

In the case of a contribution of appreciated property, the stock basis is reduced by the full amount of the contribution. As a result, when the stock is sold, the shareholder may lose the benefit of the charitable contribution deduction for the amount of any appreciation in the asset contributed.

Description of Proposal

The proposal allows a shareholder in an S corporation to increase the basis of the S corporation stock by an amount equal to the excess of the charitable contribution deduction that flows through to the shareholder over the shareholder's pro-rata share of the adjusted basis of the property contributed.[134]

Effective date.–The proposal applies to taxable years beginning after December 31, 2004.

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[132] Sec. 1366(a)(1)(A).

[133] Sec. 1367(a)(2)(B).

[134] See Rev. Rul. 96-11 (1996-1 C.B. 140) for a similar rule applicable to contributions made by a partnership.

Analysis

The proposal preserves the benefit of providing a charitable contribution deduction for contributions of property by an S corporation with a fair market value in excess of its adjusted basis by limiting the reduction in the shareholder's basis in S corporation stock to the proportionate share of the adjusted basis of the contributed property. Under the proposal, the treatment of contributions of appreciated property made by an S corporation is similar to the treatment of contributions made by a partnership.

The net reduction in basis of stock by the amount of the adjusted basis of contributed property rather than the fair market value will have little effect on tax law complexity.

Prior Action

The President's fiscal year 2003, 2004, and 2005 budget proposals contained a similar proposal.

H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a similar proposal.

S. 476, The "CARE Act of 2003," as agreed to by the Senate on April 4, 2003, contained a similar proposal.

6. Repeal the $150 million limit for qualified 501(c)(3) bonds

Present Law

Interest on State or local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is provided in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in section 501(c)(3) ("section 501(c)(3) organizations") if the activities do not constitute an unrelated trade or business.

Section 501(c)(3) organizations are treated as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(c)(3) bonds," subject to the restrictions of section 145. Prior to the Taxpayer Relief Act of 1997 (the "1997 Act"), the most significant of these restrictions limited the amount of outstanding bonds from which a section 501(c)(3) organization could benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control were treated as a single organization. The limit did not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

The "1997 Act" repealed the $150 million limit for bonds issued after the date of enactment (August 5, 1997), to finance capital expenditures incurred after such date.

Description of Proposal

The proposal repeals the $150 million limit for qualified 501(c)(3) bonds in its entirety.

Effective date.–The proposal is effective for bonds issued after the date of enactment.

Analysis

Because the 1997 Act provision applies only to bonds issued with respect to capital expenditures incurred after August 5, 1997, the $150 million limit continues to govern the issuance of other non-hospital qualified 501(c)(3) bonds (e.g., advance refunding bonds with respect to capital expenditures incurred on or before such date, new-money bonds for capital expenditures incurred on or before such date, or new-money bonds for working capital expenditures). Thus, there are two rules governing qualified 501(c)(3) bonds for capital expenditures. The application of a particular rule depends on whether the capital expenditures were incurred on or before or after the date the 1997 Act was enacted.

As noted above, the $150 million volume limit continues to apply to qualified 501(c)(3) bonds for capital expenditures incurred on or before August 5, 1997. (Typically, these will be advance refunding bonds). The limit also continues to apply to bonds more than five percent of the net proceeds of which finance or refinance working capital expenditures (i.e., operating expenses). The limit does not apply to bonds to finance capital expenditures incurred after that date. The Senate Finance Committee report states that the purpose of the repeal of the $150 million limit was to correct the disadvantage the limit placed on 501(c)(3) organizations relative to substantially identical governmental institutions:

> The Committee believes a distinguishing feature of American society is the singular degree to which the United States maintains a private, non-profit sector of private higher education and other charitable institutions in the public service. The Committee believes it is important to assist these private institutions in their advancement of the public good. The Committee finds particularly inappropriate the restrictions of present law which place these section 501(c)(3) organizations at a financial disadvantage relative to substantially identical governmental institutions. For example, a public university generally has unlimited access to tax-exempt bond financing, while a private, non-profit university is subject to a $150 million limitation on outstanding bonds from which it may benefit. The Committee is concerned that this and other restrictions inhibit the ability of America's private, non-profit institutions to modernize their educational facilities. The Committee believes the tax-exempt bond rules should treat more equally State and local governments and those private organizations which are engaged in similar actions advancing the public good.[135]

Although the conference report on the 1997 Act noted the continued applicability of the $150 million limitation to refunding and new-money bonds, no reason was given for retaining

[135] S. Rep. 105-33 (June 20, 1997), at 24-25.

the rule.[136] Thus, it appears that eliminating the discrepancy between pre-August 5, 1997, and post-August 5, 1997, capital expenditures would not violate the policy underlying the repeal of the $150 million limitation. Some may argue that the $150 million volume limit should continue to apply to qualified 501(c)(3) bonds more than five percent of the net proceeds of which finance or refinance working capital expenditures (i.e., operating expenses). Unlike bond proceeds financing capital expenditures, bond proceeds financing working capital expenditures are not directly used to modernize educational facilities, but are used to finance operating expenses. Proponents may respond that Congress intended to eliminate the disparity between 501(c)(3) organizations and substantially identical governmental institutions in the 1997 Act and this only can be achieved by complete repeal of the $150 million.

Prior Action

A similar proposal was included in the President's fiscal year 2004 and 2005 budget proposals.

7. Repeal the restrictions on the use of qualified 501(c)(3) bonds for residential rental property

Present Law

In general

Interest on State or local government bonds is tax-exempt when the proceeds of the bonds are used to finance activities carried out by or paid for by those governmental units. Interest on bonds issued by State or local governments acting as conduit borrowers for private businesses is taxable unless a specific exception is included in the Code. One such exception allows tax-exempt bonds to be issued to finance activities of non-profit organizations described in Code section 501(c)(3) ("qualified 501(c)(3) bonds").

For a bond to be a qualified 501(c)(3) bond, the bond must meet certain general requirements. The property that is to be provided by the net proceeds of the issue must be owned by a 501(c)(3) organization, or by a government unit. In addition, a bond failing both a modified private business use test and a modified private security or payment test would not be a qualified 501(c)(3) bond. Under the modified private business use test at least 95 percent of the net proceeds of the bond must be used by a 501(c)(3) organization in furtherance of its exempt purpose. Under a modified private security or payment test, the debt service on not more than 5 percent of the net proceeds of the bond issue can be (1) secured by an interest in property, or payments in respect of property, used by a 501(c)(3) organization in furtherance of an unrelated trade or business or by a private user, or (2) derived from payments in respect of property, or borrowed money, used by a 501(c)(3) organization in furtherance of an unrelated trade or business or by a private user.

[136] H. Rep. 105-220 (July 30, 1997), at 372-373.

Qualified 501(c)(3) bonds are not subject to (1) the State volume limitations, (2) the land and existing property limitations, (3) the treatment of interest as a preference item for purposes of the alternative minimum tax and (4) the prohibition on advance refundings.

Qualified residential rental projects

In general

The Code provides that a bond which is part of an issue shall not be a qualified 501(c)(3) bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units (sec. 145(d)(1)). Exceptions to this rule are provided for facilities that meet the low-income tenant qualification rules for qualified residential rental projects financed with exempt facility private activity bonds,[137] or are new or substantially rehabilitated (sec. 142(d) and 145(d)(2)).

Acquisition of existing property

Qualified 501(c)(3) bonds issued to acquire existing residential rental property that is not substantially rehabilitated must meet certain low-income tenant qualification rules. Section 142(d) sets forth those rules. Section 142(d) requires for the qualified project period (generally 15 years) that (1) at least 20 percent of the housing units must be occupied by tenants having incomes of 50 percent or less of area median income or (2) 40 percent of the housing units in the project must be occupied by tenants having incomes of 60 percent or less of the area median income.

New construction or substantial rehabilitation

In the case of a "qualified residential rental project" that consists of new construction or substantial rehabilitation, qualified 501(c)(3) bonds are not required to meet the low-income tenant qualification rules that otherwise would be applicable.

Description of Proposal

The proposal repeals the low-income tenant qualification and substantial rehabilitation rules for the acquisition of existing property with qualified 501(c)(3) bonds.

Effective date.–The proposal is effective for bonds issued after the date of enactment.

Analysis

The current low-income tenant rules to qualified 501(c)(3) bonds resulted from Congressional concern that qualified 501(c)(3) bonds were being used in lieu of exempt facility

[137] Section 142(a)(7) describes an exempt facility bond as any bond issued as part of an issue of bonds if 95 percent or more of the net proceeds of the issue are to be used to provide qualified residential rental projects.

bonds to avoid the low-income tenant rules applicable to exempt facility bonds. The Ways and Means Committee report noted:

> The Committee has become aware that, since enactment of the Tax Reform Act of 1986, many persons have sought to avoid the rules requiring that, to qualify for tax-exempt financing, residential rental property serve low-income tenants to a degree not previously required. The most common proposals for accomplishing this result have been to use qualified 501(c)(3) or governmental bonds to finance rental housing. Frequently, the proposals have involved the mere churning of "burned-out" tax shelters with the current developers remaining as project operators under management contracts producing similar returns to those they received in the past. The committee finds it anomalous that section 501(c)(3) organizations–charities–would attempt in these or any other circumstances to finance with tax-exempt bonds rental housing projects that serve a more affluent population group than those permitted to be served by projects that qualify for tax-exempt exempt-facility bond financing.[138]

In conference, the applicability of the low-income tenant rules was limited to the acquisition of existing property.[139] It has been argued that the disparity in the treatment of existing facilities versus new facilities causes complexity. Some degree of simplification might be achieved through the elimination of the low-income tenant rules. Nonetheless, some might argue that the concerns that prompted the application of the low-income tenant rules to existing property would once again arise upon removal of these limitations.

There have been reports that there is a shortage of affordable rental housing. By removing the restrictions on existing property, some might argue that charities would not be inclined to serve low-income tenants to the same degree. Proponents of the restrictions might argue that charities, in particular, should provide affordable housing to low-income persons as part of their charitable mission to serve the poor and distressed.

Others might argue that an affordable housing shortage is not widespread and that such issues would be better addressed through efforts to directly assist low-income persons rather than by imposing restrictions on the property acquired by the charity. Further, because qualified 501(c)(3) bonds are to be used to further the exempt purposes of the charity, there is a limit on the extent the charity can operate like a commercial enterprise.

As noted above, the interest on qualified 501(c)(3) bonds is exempt from tax, and is not a preference for purpose of the alternative minimum tax. Unlike some other private activity bonds,

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[138] H.R. Rep. No. 100-795 at 585 (1988). The report also noted: "The press has reported housing industry representatives stating publicly that a primary attraction of some housing financed with governmental and qualified 501(c)(3) bonds is that the low-income tenant requirements and State volume caps applicable to for-profit developers do not apply." *Id*.

[139] H.R. Conf. Rep. 100-1104, vol. II at 126 (1988).

qualified 501(c)(3) bonds are not subject to the State volume limitations and therefore, do not have to compete with other private activity bond projects for an allocation from the State. Proponents of the restrictions might argue that the restrictions are not unreasonable given the preferential status of qualified 501(c)(3) bonds and the fact that such charities could be viewed as helping alleviate a burden on government to benefit those most in need.

Prior Action

A similar proposal was included in the President's fiscal year 2004 and 2005 budget proposals.

D. Extend, Increase, and Expand the Above-the-Line Deduction for Qualified Out-of-Pocket Classroom Expenses

Present Law

Deduction for out-of-pocket classroom expenses incurred by teachers and other educators

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $145,950 (for 2005). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2006, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school which provides elementary education or secondary education, as determined under State law.

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

General rules regarding education expenses

An individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.[140] Education expenses are not deductible if

[140] Treas. Reg. sec. 1.162-5.

they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during a taxable year that are required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible educational institution of higher education for courses of instruction of such individual at such institution.[141]

Unreimbursed educational expenses incurred by employees

In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous itemized deductions, exceed two percent of the taxpayer's adjusted gross income. Itemized deductions subject to the two-percent floor are not deductible for minimum tax purposes. In addition, present law imposes a reduction on most itemized deductions, including the employee business expense deduction, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2005 is $145,950 ($72,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases-out the overall limitation on itemized deductions for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009, although this elimination of the limitation sunsets on December 31, 2010.[142]

Contributions to a school may be eligible for a charitable contribution deduction under section 170. A contribution that qualifies both as a business expense and a charitable contribution may be deducted only as one or the other, but not both.

Description of Proposal

The present-law provision would be made permanent and the maximum deduction increased to $400. As under current law, the provision would apply to teachers and other school personnel employed by public entities, charter schools or private schools (as determined under state law). The current-law 900-hour rule would be clarified to refer to a school year ending during the taxable year. Eligible, unreimbursed expenses would be expanded to include teacher

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[141] Sec. 222.

[142] A separate proposal contained in the President's fiscal year 2006 budget permanently extends the elimination of the overall limitation on itemized deductions after 2010 (I.A.,above).

training expenses related to current teaching positions. Neither travel nor lodging expenses nor expenditures related to religious instruction or activities would be eligible. Expenses claimed as an above-the-line deduction could not be claimed as an itemized deduction or taken into account in determining any other tax benefit such as Hope or lifetime learning credits. Taxpayers would be required to retain receipts for eligible expenditures along with a certification from a principal or other school official that the expenditures qualified. The proposal would be effective for expenses incurred in taxable years beginning after December 31, 2005.

Effective date.–The proposal is effective for expenses incurred in taxable years beginning after December 31, 2005.

Analysis

Policy issues

The proposal and the present-law section 62 above-the-line deduction attempt to make fully deductible many of the legitimate business expenses of eligible schoolteachers. As described below, and absent an above-the-line deduction, the expenses might otherwise be deductible except for the two-percent floor that applies to miscellaneous itemized deductions. Some have observed that the two-percent floor increases pressure to enact above-the-line deductions on an expense-by-expense basis. In addition to increasing complexity, the expense-by-expense approach is not fair to other taxpayers with legitimate business expenses that remain subject to the two-percent floor. For example, emergency response professionals incur similar unreimbursed expenses related to their employment, a deduction for which also has been separately proposed.[143]

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

Complexity issues

Three provisions of present law restrict the ability of teachers to deduct as itemized deductions those expenses covered by the proposal: (1) the two-percent floor on itemized deductions; (2) the overall limitation on itemized deductions; and (3) the alternative minimum tax. The staff of the Joint Committee on Taxation has previously identified these provisions as

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

sources of complexity and has recommended that such provisions be repealed.[144] These provisions do not apply to eligible expenses under the proposal. While repealing these provisions for all taxpayers reduces the complexity of the Federal tax laws, effectively repealing these provisions only for certain taxpayers (such as teachers and other eligible educators) likely increases complexity.

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

The proposal and the present-law above-the-line deduction do not completely eliminate the need to apply the present-law rules regarding itemized deductions. For example, a teacher with expenses in excess of the $400 cap under the proposal or with other miscellaneous itemized deductions may need to compute tax liability under the present-law itemized deduction rules as well as under the proposal. In addition, the proposal does not cover all classroom expenses, but only those that meet the particular requirements of the proposal. Expenses that do not meet those requirements remain subject to the present-law rules. Similarly, some expenses may either be deductible under the proposal or used for tax benefits under other provisions. For example, certain teacher education expenses may be deductible under the proposal or used for a Hope or Lifetime Learning credit. Taxpayers with such expenses need to determine tax liability in more than one way in order to determine which provisions result in the lowest tax liability. In addition, overlapping provisions increase the likelihood that some taxpayers inadvertently claim more than one tax benefit with respect to the same expense.

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, and 2005 budget proposals. A similar provision relating only to the extension of the availability of the deduction was contained in the Working Families Tax Relief Act of 2004.[145]

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

[145] Pub. Law. No 108-311. sec. 307 (2004).

E. Exclude from Income of Individuals the Value of Employer-Provided Computers, Software, and Peripherals

Present Law

The value of computers, software, or other office equipment provided by an employer for use in the home of an employee is generally excludable from income as a working condition fringe benefit to the extent the equipment is used to perform work for the employer (sec. 132). The value of such equipment is includible in income to the extent the equipment is used for personal purposes. If such equipment is used for both personal and business purposes, then a portion of the value may be excluded from income.

In general, employee business expenses are deductible as an itemized deduction, but only to the extent such expenses and other miscellaneous itemized deductions exceed two percent of adjusted gross income. Impairment-related work expenses are not subject to this two-percent floor. Impairment-related work expenses are expenses: (1) of a handicapped individual for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work; and (2) that are trade or business expenses (sec. 162). For these purposes, a handicapped individual means an individual who has a physical or mental disability (including but not limited to blindness or deafness) which for such individual constitutes or results in a functional limitation to employment or who has any physical or mental impairment (including, but not limited to, a sight or hearing impairment) which substantially limits one or more major life activities of such individual.

Description of Proposal

The proposal provides an exclusion from income for the value of any computers, software or other office equipment provided to an individual by that individual's employer. The exclusion is limited to equipment necessary for the individual to perform work for the employer at home but is not limited to business use of such equipment. Therefore, the exclusion applies to all use of such equipment, including use by the employee for personal purposes or to carry on a trade or business other than working as an employee of the employer. However, in order to qualify for the exclusion, the employee is required to make substantial use of the equipment to perform work for the employer.

If the employer provided the employee with the use of the equipment at the end of its useful life, the proposal also deems the value of such use to be zero for tax purposes.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2005.

Analysis

Complexity issues

One purpose of the proposal may be a simplification purpose, that is, to reduce record keeping for employees to whom an employer provides office equipment. The proposal eliminates the need to keep track of personal versus business use of covered equipment.

However, the proposal gives rise to new tax law complexity because it would add a new factual determination ("substantial" business use) as a criterion for the tax benefit it provides. The proposal does not specify what constitutes "substantial" business use for these purposes. Because any standard for making this determination involves a factual inquiry, the proposal increases the complexity of tax administration by increasing the likelihood of factual disputes and litigation.

Policy issues

Under normal income tax principles, if an employer pays an employee cash, the cash is taxable as income to the employee regardless of whether the employee uses the cash to purchase a computer and software for personal use or whether the employee purchases other consumer goods for personal consumption. Thus, under normal income tax principles, when an employer provides any item of value to an employee, the value of the good or service provided to the employee should be included in the taxable income of the employee, because the provision of the good or service is a form of compensation. The proposal excludes the value of computer hardware and software provided to certain employees for personal use from the taxable income of the employees.

If certain forms of compensation are not taxed to the employee, the employer is indifferent (the employer's outlay is deductible as compensation regardless of whether in cash or in kind), but the employee will find the untaxed forms of compensation more valuable. For example, if a taxpayer in the 15-percent income tax bracket sought to purchase a $1,000 computer system, the taxpayer would have to earn $1,176 in income in order to have the $1,000 after-tax income sufficient to purchase the computer system. If the employer can provide the computer system to the employee and the value of the system is excluded from the employee's taxable income, it is equivalent to the employee receiving a 15-percent discount on the price of the computer system. Alternatively, it is equivalent to the employee having received an additional $176 in compensation. More generally, for a taxpayer whose marginal income tax rate is t, if the employer can provide the computer system to the employee and the value of the system is excluded from the employee's taxable income, it is equivalent to the employee receiving a t-percent discount on the price of the computer system or, alternatively, it is equivalent to the employee having received an additional 1/(1-t) percentage increase in compensation. Generally, if the price of a good declines, consumers purchase more of the good. In this context, this could result in employees seeking more compensation in the form of untaxed computer goods and services and less in the form of taxable compensation.

Exempting certain forms of compensation from taxable income also has the potential create economic inefficiencies. Because certain employees do not bear the full cost of computer

hardware and software, some employees may purchase more computer hardware and software than they need. By favoring computers, the proposal favors certain methods of enabling employees (those based on computer applications) over others. As a result, other strategies that could raise the well being of employees may be forgone.

Prior Action

A similar proposal was included in the President's fiscal year 2002, 2003, 2004, and 2005 budget proposals.

F. Establish Opportunity Zones

Present Law

In general

The Internal Revenue Code contains various incentives to encourage the development of economically distressed areas, including incentives for businesses located in empowerment zones, enterprise communities and renewal communities, the new markets tax credit, the work opportunity tax credit, and the welfare-to-work tax credit.

Empowerment zones

There are currently 40 empowerment zones–30 in urban areas and 10 in rural areas–that have been designated through a competitive application process. State and local governments nominated distressed geographic areas, which were selected on the strength of their strategic plans for economic and social revitalization. The urban areas were designated by the Secretary of the Department of Housing and Urban Development. The rural areas were designated by the Secretary of the Department of Agriculture. Designations of empowerment zones will remain in effect until December 31, 2009.

Incentives for businesses in empowerment zones include (1) a 20-percent wage credit for qualifying wages, (2) additional expensing for qualified zone property, (3) tax-exempt financing for certain qualifying zone facilities, (4) deferral of capital gains on sales and reinvestment in empowerment zone assets, and (5) exclusion of 60 percent (rather than 50 percent) of the gain on the sale of qualified small business stock held more than 5 years.

The wage credit provides a 20 percent subsidy on the first $15,000 of annual wages paid to residents of empowerment zones by businesses located in these communities, if substantially all of the employee's services are performed within the zone. The credit is not available for wages taken into account in determining the work opportunity tax credit.

Enterprise zone businesses are allowed to expense the cost of certain qualified zone property (which, among other requirements, must be used in the active conduct of a qualified business in an empowerment zone) up to an additional $35,000 above the amounts generally available under section 179.[146] In addition, only 50 percent of the cost of such qualified zone property counts toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

Qualified enterprise zone businesses are eligible to apply for tax-exempt financing (empowerment zone facility bonds) for qualified zone property. These empowerment zone

[146] Section 179 provides that, in place of depreciation, certain taxpayers, typically small businesses, may elect to deduct up to $100,000 of the cost of section 179 property placed in service each year. In general, section 179 property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

facility bonds do not count against state private activity bond limits, instead a limit is placed upon each zone, depending on population and whether the zone is in an urban or rural area.

Enterprise communities

Current law authorized the designation of 95 enterprise communities, 65 in urban areas and 30 in rural areas. Qualified businesses in these communities were entitled to similar favorable tax-exempt financing benefits as those in empowerment zones. Designations of enterprise communities were made in 1994 and remained in effect through 2004. Many enterprise communities have since been re-designated as part of an empowerment zone or a renewal community.

Renewal communities

The Community Renewal Tax Relief Act of 2000 authorized 40 renewal communities, at least 12 of which must be in rural areas. Forty renewal communities have been chosen through a competitive application process similar to that used for empowerment zones. The 40 communities were designated by the Department of Housing and Urban Development in 2002 and that designation continues through 2009.

Renewal community tax benefits include: (1) a 15-percent wage credit for qualifying wages; (2) additional section 179 expensing for qualified renewal property; (3) a commercial revitalization deduction; and (4) an exclusion for capital gains on qualified community assets held more than five years.

The wage credit and increased section 179 expensing operate in a similar fashion as in empowerment zones. The primary difference is that the wage credit is smaller, equal to 15 percent for the first $10,000 of wages.

The commercial revitalization deduction applies to certain nonresidential real property or other property functionally related to nonresidential real property. A taxpayer may elect to either: (1) deduct one-half of any qualified revitalization expenditures that would otherwise be capitalized for any qualified revitalization building in the tax year the building is placed in service; or (2) amortize all such expenditures ratably over a 120-month period beginning with the month the building is placed in service. A qualified revitalization building is any nonresidential building and its structural components placed in service by the taxpayer in a renewal community. If the building is new, the original use of the building must begin with the taxpayer. If the building is not new, the taxpayer must substantially rehabilitate the building and then place it in service. The total amount of qualified revitalization expenditures for any building cannot be more than the smaller of $10 million or the amount allocated to the building by the commercial revitalization agency for the state in which the building is located. A $12 million cap on allowed commercial revitalization expenditures is placed on each renewal community annually.

New markets tax credit

The new markets tax credit provides a tax credit to investors who make “qualified equity investments” in privately-managed investment vehicles called “community development entities,” or “CDEs.” The CDEs must apply for and receive an allocation of tax credit authority

from the Treasury Department and must use substantially all of the proceeds of the qualified equity investments to make qualified low-income community investments. One type of qualified low-income community investment is an investment in a qualified active low-income community business. In general, a "qualified active low-income community business" is any corporation (including a nonprofit corporation), partnership or proprietorship that meets the following requirements:

- At least 50 percent of the gross income of the business is derived from the active conduct of a qualified business within a low-income community (as defined in section 45D(e)). For this purpose, a "qualified business" generally does not include (1) the rental of real property other than substantially improved nonresidential property; (2) the development or holding of intangibles for sale or license; (3) the operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or a liquor store; or (4) farming if the value of the taxpayer's assets used in the business exceeds $500,000.
- At least 40 percent of the use of the tangible property of the business is within a low-income community.
- At least 40 percent of the services performed for the business by its employees are performed in a low-income community.
- Collectibles (other than collectibles held primarily for sale to customers in the ordinary course of business) constitute less than five percent of the assets of the business.
- Nonqualified financial property (which includes debt instruments with a term in excess of 18 months) comprises less than five percent of the assets of the business.

A portion of a business may be tested separately for qualification as a qualified active low-income community business.

Work opportunity and welfare-to-work tax credits

Employers may be entitled to a work opportunity tax credit or a welfare-to-work tax credit for certain wages paid to eligible employees.

Description of Proposal

In general

The proposal creates forty opportunity zones, 28 in urban areas and 12 in rural areas. The zone designation and corresponding incentives for these 40 zones are in effect from January 1, 2006, to December 31, 2015. As described below, the tax incentives applicable to opportunity zones include: (1) an exclusion of 25 percent of taxable income for opportunity zone businesses with average annual gross receipts of $5 million or less; (2) additional section 179 expensing for opportunity zone businesses; (3) a commercial revitalization deduction; and (4) a wage credit for businesses that employ opportunity zone residents within the zone.

Selection of opportunity zones

The Secretary of Commerce selects opportunity zones through a competitive process. A county, city or other general purpose political subdivision of a state (a "local government") is eligible to nominate an area for opportunity zone status if the local government is designated by the Secretary of Commerce as a "Community in Transition." Two or more contiguous local governments designated as Communities in Transition may submit a joint application.

A local government may be designated as a Community in Transition if it has experienced the following: (1) a loss of at least three percent of its manufacturing establishments from 1993 to 2003 (urban areas must have had at least 100 manufacturing establishments in 1993); (2) a loss of at least three percent of its retail establishments from 1993 to 2003; and (3) a loss of at least 20 percent of its manufacturing jobs from 1993 to 2003.

Local governments not making the original Community in Transition list may appeal to the Secretary of Commerce. Other factors demonstrating a loss of economic base within the local government may be considered in the appeal.

Applicants for opportunity zone status have to develop and submit a "Community Transition Plan" and a "Statement of Economic Transition." The Community Transition Plan must set concrete, measurable goals for reducing local regulatory and tax barriers to construction, residential development and business creation. Communities that have already worked to address these issues receive credit for recent improvements. The Statement of Economic Transition must demonstrate that the local community's economic base is in transition, as indicated by a declining job base and labor force, and other measures, during the past decade.

In evaluating applications, the Secretary of Commerce may consider other factors, including: (1) changes in unemployment rates, poverty rates, household income, homeownership and labor force participation; (2) the educational attainment and average age of the population; and (3) for urban areas, the number of mass layoffs occurring in the area's vicinity over the previous decade.

The majority of a nominated area must be located within the boundary of one or more local governments designated as a Community in Transition. A nominated area would have to have a continuous boundary (that is, an area must be a single area; it cannot be comprised of two or more separate areas) and may not exceed 20 square miles if an urban area or 1,000 square miles if a rural area.

A nominated urban area must include a portion of at least one local government jurisdiction with a population of at least 50,000. The population of a nominated urban area may not exceed the lesser of: (1) 200,000; or (2) the greater of 50,000 or ten percent of the population of the most populous city in the nominated area. A nominated rural area must have a population of at least 1,000 and no more than 30,000.

"Rural area" is defined as any area that is (1) outside of a metropolitan statistical area (within the meaning of section 143(k)(2)(B)) or (2) determined by the Secretary of Commerce,

after consultation with the Secretary of Agriculture, to be a rural area. "Urban area" is defined as any area that is not a rural area.

Empowerment zones and renewal communities are eligible to apply for opportunity zone status, but are required to relinquish their current status and benefits once selected. Opportunity zone benefits for converted empowerment zones and renewal communities expire on December 31, 2009. The selection of empowerment zones or renewal communities to convert to opportunity zones is based on the same criteria that apply to other communities, but does not count against the limitation of 40 new opportunity zones.

Enterprise communities are also eligible to apply for opportunity zone status. Aside from automatically being eligible to apply, enterprise communities are treated as other areas that do not belong to either an empowerment zone or a renewal community once selected: benefits are in effect for 10 years and the selection of an enterprise community as an opportunity zone counts against the limit of 40 new opportunity zones.

Reporting requirements identifying construction, residential development, job creation, and other positive economic results apply to opportunity zones.

Tax incentives applicable to opportunity zones

Exclusion of 25 percent of taxable income for certain opportunity zone businesses

A business is allowed to exclude 25 percent of its taxable income if (1) it qualified as an "opportunity zone business" and (2) it satisfied a $5 million gross receipts test. The definition of an opportunity zone business is based on the definition of a "qualified active low-income community business" for purposes of the new markets tax credit, treating opportunity zones as low-income communities. However, a nonprofit corporation does not qualify for treatment as an opportunity zone business. In addition, a portion of a business may not be tested separately for qualification as an opportunity zone business. The $5 million gross receipts test is satisfied if the average annual gross receipts of the business for the three-taxable-year period ending with the prior taxable year does not exceed $5 million. Rules similar to the rules of section 448(c) apply.

Additional section 179 expensing

An opportunity zone business is allowed to expense the cost of section 179 property that is qualified zone property, up to an additional $100,000 above the amounts generally available under section 179. In addition, only 50 percent of the cost of such qualified zone property counts toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

Commercial revitalization deduction

A commercial revitalization deduction is available for opportunity zones in a manner similar to the deduction for renewal communities. A $12 million annual cap on these deductions applies to each opportunity zone.

Wage credit

Individuals who live and work in an opportunity zone constitute a new target group with respect to wages earned within the zone under a combined work opportunity tax credit and welfare-to-work tax credit, as proposed by the President under a separate proposal.

Other benefits for opportunity zones

Individuals, organizations, and governments within an opportunity zone receive priority designation when applying for new markets tax credits and the following other federal programs: 21st Century After-school, Early Reading First, and Striving Readers funding; Community Based Job Training Grants; Community Development Block Grants, Economic Development Administration grants, and HOME Funding; and USDA Telecommunications Loans, Distance Learning and Telemedicine grants, and Broadband loans.

Analysis

The proposal is designed to provide tax benefits to local areas with declines in manufacturing employment and other reductions of the local economic base. In particular, the proposal encourages the development and growth of small businesses within local areas designated as Communities in Transition.

The tax benefits are available to "Communities in Transition," which are defined as communities that have suffered declines in manufacturing and retail industries. The proposal may thus have the effect of providing incentives to communities negatively affected by increased international trade. Economic theory provides that international trade generates net benefits to a nation's economy, but that those benefits are unevenly distributed among sectors within the economy. However, the existence of net benefits suggests that sufficient national resources should exist to compensate fully those sectors hurt by trade. The proposal is consistent with the aims of this policy of compensation.

Opponents of the proposal might argue that the proposal extends tax benefits not only to communities that have suffered a decline in manufacturing and retail establishments but also to neighboring, prospering communities. This is because the proposal requires only that a majority of an opportunity zone consist of territory located in a Community in Transition. Thus, tax benefits may potentially be allocated to individuals and businesses whose activities may not significantly contribute to economic development in the Community in Transition.

Some observers have noted that a challenge to full utilization of existing local development tax incentives (such as empowerment zones) is the ever-growing menu of zones and tax benefits. Local officials have a difficult time explaining complicated sets of policies to businesses. The proposal adds to the list of benefits in the form of a 25-percent taxable income exclusion, which is available for opportunity zones but not for other similar targeted areas. Critics of existing empowerment zones and renewal communities policies argue that for full utilization of such tax benefits to be achieved, there needs to be increased funding of programs educating individuals and business of the benefits of existing tax incentives.

Allowing the conversion of existing zones to opportunity zones offers an opportunity consolidate and simplify tax benefits for distressed economic areas. However, the incentive for existing empowerment zones and renewal communities to convert to opportunity zone status is reduced by the early termination date. Further, the differences in the set of tax incentives available to the various zones may reduce the incentive of local government officials to request conversion. Such officials have developed expertise and development plans based on the existing set of tax benefits.

The gross receipts test for a qualified opportunity zone business creates a "cliff" with respect to this tax benefit. Businesses who find themselves marginally in excess of the three-year moving-average cease to qualify for the income exclusion. Thus, this formulation of the income exclusion unfairly distinguishes between similarly situated businesses and offers an incentive for abuse. However, this formulation of the taxable income exclusion focuses the tax benefit to small businesses.

Further, as is the case with other tax incentives for economically-distressed areas, some observers note that the tax benefits may do little to encourage new development. Hence, such incentives may primarily benefit existing businesses while producing little new growth. Indeed, the establishment of local tax incentives may have the effect of distorting the location of new investment, rather than increasing investment overall.[147] If the new investments are offset by less investment in neighboring, but not qualifying areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

Prior Action

No prior action.

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

G. Provide Tax Relief for Federal Emergency Management Agency Hazard Mitigation Assistance Programs

Present Law

Gross income includes all income from whatever source derived unless a specific exception applies.

Gross income does not include amounts received by individuals as qualified disaster relief payments.[148] Qualified disaster relief payments include amounts (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster; (2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence to the extent need is attributable to a qualified disaster; (3) by a person engaged in the furnishing or sale of transportation by reason of the death or personal injuries as a result of a qualified disaster, and (4) amounts paid by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare.

In addition to providing grants in the aftermath of a natural disaster, the Federal Emergency Management Agency ("FEMA") of the Department of Homeland Security conducts disaster mitigation assistance programs to provide grants through State and local governments for businesses and individuals to mitigate potential damage from future natural disasters. For example, grants may fund modifications to structures (e.g., homes or businesses) or may be used to purchase property located in disaster prone areas.

There is no specific exclusion from gross income for amounts received pursuant to FEMA mitigation grants.[149] FEMA provides these grants through State and local governments to mitigate potential damage from future natural hazards. The existing statutory exclusion under present law for qualified disaster relief payments only applies to amounts received by individuals as a result of a disaster that has occurred.

If certain requirements are met, section 1033 provides that if property is compulsory or involuntarily converted and replaced within a certain period (generally two years), there is deferral of gain recognition. In general, the cost basis in the replacement property is the carry-over basis in the converted property (decreased by the amount of any money or loss and increased by the amount of any gain recognized on the conversion).

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[148] Sec. 139.

[149] See IRS Chief Counsel Memorandum 200431012 (June 29, 2004), which concluded that foundation elevations provided through payments made directly or indirectly from FEMA mitigation grants are includible in gross income of property owners. Various types of disaster payments made to individuals have been excluded from gross income administratively under a general welfare exception. The general welfare exception does not apply to disaster mitigation payments.

In the case of the sale or exchange of a principal residence, current law allows an exclusion of up to $250,000 ($500,000 in the case of a joint return) if the property was used as the taxpayer's principal residence for two or more years during the five-year period ending on the date of the sale or exchange.

Description of Proposal

The proposal provides an exclusion from gross income for certain amounts received as FEMA disaster mitigation grants. Under the proposal, if FEMA pays the cost of improving property pursuant to a mitigation assistance program (e.g., retrofitting or elevating), the cost of such improvement is excluded from gross income. However, under the proposal, there is no increase in the owner's cost basis in the property. The proposal also provides that a business that receives a tax-free mitigation grant and uses the grant to purchase or repair property cannot claim a deduction for those expenses.

The exclusion does not apply to payments from FEMA in connection with the acquisition, through a mitigation assistance program, of property located in a disaster or hazard area. However, if a property is sold or disposed to implement hazard mitigation, such sale or disposition is treated as an involuntary conversion under section 1033.

Effective date.–The proposal is generally effective for mitigation assistance received after December 31, 2004. The proposal provides Treasury administrative authority to provide retroactive relief.

Analysis

The proposal provides an exclusion from gross income for amounts received as FEMA disaster mitigation payments. Amounts excludable under the proposal include amounts received directly or indirectly as payment or benefit by a property owner for hazard mitigation with respect to property pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act. Payments are made pursuant to the Flood Mitigation Assistance Program, the Pre-Disaster Mitigation Program, and the Hazard Mitigation Grant Program.

Some believe that requiring FEMA mitigation grants to be included in income is a deterrent for individuals and business to participate in disaster mitigation programs. Some participants may not have the cash necessary to pay the tax imposed on the benefits provided by the mitigation grants. The proposal is intended to remove this potential impediment to participation in the programs. Because successful mitigation can be more cost effective for the Federal government that repair after the occurrence of a disaster, many believe that allowing an exclusion for payments made to mitigation program participants translates into net benefits for the government.

Payments can be made, for example, to elevate a home located in an area prone to floods. Under the proposal, the homeowner is not required to include the value of the improvement in income. The proposal provides that there is no increase in an owner's cost basis for amounts received pursuant to a mitigation assistance program that are excluded from income. Thus, if the property is later sold, any gain resulting from the mitigation assistance would be taxable, subject

to any exclusion otherwise available (e.g., the exclusion under section 121 of gain from the sale of a principal residence). A reduced tax rate would apply for any amounts includible in income in excess of any exclusion otherwise available.

The proposal provides that a business that receives a tax-free mitigation grant and uses the grant to purchase or repair property cannot claim a deduction for those expenses. It may be appropriate to apply this denial of double benefit rule on a broader basis, rather than limiting it only to businesses.

FEMA mitigation payments can also be made to acquire property located in a disaster area. Under the proposal, amounts received for the sale or disposition of properties for the purposes of hazard mitigation are not eligible for the income exclusion. However, if a property is sold or disposed to implement hazard mitigation, such sale or disposition is treated as an involuntary conversion, under section 1033 of the Internal Revenue Code. Thus, under the proposal, if property is sold by a taxpayer through a FEMA disaster mitigation program and the taxpayer replaces the property within the period specified under present law in the case of an involuntary conversion (i.e., generally two years), instead of including the compensation in gross income, the taxpayer has carry-over cost basis in the replacement property. Proponents view this result as more appropriate compared with allowing an exclusion for payments made to acquire property located in a disaster area. Others argue that allowing involuntary conversion treatment is inappropriate, as there are many other cases in which the government acquires private property and involuntary conversion treatment is not available.

Many view an exclusion for FEMA mitigation payments similar to the exclusion provided under the Code for qualified disaster relief payments. They argue that since an exclusion applies to payments made to victims after a qualified disaster, it is also appropriate to allow an exclusion for payments made to mitigate future disaster damage.

The proposal provides Treasury administrative authority to provide retroactive tax relief. The extent of the retroactive relief is unclear. For example, it is unclear whether the proposal contemplates waiving the statute of limitations or if any retroactive relief provided by Treasury would apply only to open taxable years. Retroactivity promotes complexity and adds additional burdens for both taxpayers and the IRS.

Prior Action

No prior action.

H. Provide a Tax Credit for Developers of Affordable Single-Family Housing

Present Law

The low-income housing tax credit (the "LIHC") may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures. The aggregate credit authority provided annually to each State is $1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The $1.75 per resident cap is indexed for inflation.

Description of Proposal

The proposal creates a single-family housing tax credit. Pursuant to a plan of allocation, State or local housing credit agencies will award first-year credits to new or rehabilitated housing units comprising a project for the development of single-family housing in census tracts with medium incomes of 80 percent or less of the greater of area or statewide median income or areas of chronic economic distress designated within five years prior to allocation.

Eligible taxpayers generally are the developer or investor partnership owning the qualified housing unit immediately prior to the date of sale to a qualified buyer. The maximum credit for each unit cannot exceed the present value of 50-percent of the eligible basis of that housing unit. Rules similar to the present-law rules for the LIHC determine eligible basis for this credit. Neither land nor existing structures are included in eligible basis for purposes of this credit. Units in rehabilitated structures qualify for the credit only if rehabilitation expenditures exceeded $25,000. This credit is claimed over the five-year period beginning the later of the date of sale of the unit to a qualified buyer or the date a certificate of occupancy for that unit is issued. A qualified buyer means an individual with income of 80 percent (70 percent for families with less than three members) or less of area median income. A qualified buyer will not have to be a first-time homebuyer.

Similar to the present-law low-income rental housing tax credit, this credit provides the greater of $1.90 per capita or $2.180 million of tax credit authority annually to each State beginning in calendar year 2006. These amounts are indexed for inflation. Each State (or local government) allocates its credit authority to the qualified developers or investor partnerships that own the housing unit immediately prior to the date of sale to a qualified buyer (or, if later, the date a certificate of occupancy was issued). Units in condominiums and cooperatives are treated as single-family housing for purposes of the credit. Credits allocated to a housing unit will revert to the allocating agency unless expenditures equal to at least 10 percent of the total reasonably expected qualifying costs with respect to that housing unit were expended during the first six months after the allocation. Rules similar to the present-law LIHC rules will apply regarding

plans on allocations, credit carryforwards, credit returns and a national pool of unused allocations.

The qualified developers or investor partnerships will claim the credit for the five years after the qualified property is sold to a qualified buyer. However, no credit is allowed with respect to a housing unit unless that unit was sold within the one-year period beginning on the date a certificate of occupancy was issued with regard to that unit. Rules similar to the present-law LIHC rules apply to determination of eligible basis, present value calculations and reporting requirements.

A qualified homebuyer (not the developer or investor partnership) is subject to recapture if the qualified homebuyer (or subsequent buyer) sells to a non-qualified buyer within three years of the initial sale of the qualified unit. The recapture tax is the lesser of: (1) 80 percent of the gain upon resale, or (2) a recapture amount. The recapture amount equals one half the gain resulting from the resale, reduced by $1/36^{th}$ of that value for each month between the initial sale and the sale to the nonqualified buyer. If a housing unit for which any credit was claimed is converted to rental property within the initial three-year period, then no deductions for depreciation or property taxes can be claimed with respect to such unit for the balance of that three-year period. The proposal does not provide how the qualified homebuyer (or subsequent buyer) will ascertain the recapture amount for their housing unit.

Effective date.–The proposal is effective for first-year credit allocations beginning in calendar year 2006.

Analysis

Complexity issues

The proposal adds to complexity in the tax law by creating a new tax credit with numerous detailed rules and significant record keeping requirements for both the taxpayer claiming the credit and subsequent homebuyers. This new credit, like the low-income rental housing credit upon which it is based, will be inherently complex and detailed, and will require significant additional paperwork by taxpayers. The proposal will require the creation of additional tax forms and will require the Internal Revenue Service to devote resources to the administration and enforcement of the rules under the proposal. Also, a system to identify qualified buyers and advertise qualified properties for sale to such buyers will need to be developed. This proposal may give rise to an increase in the number of individual taxpayers requiring third-party assistance in preparing their tax returns. The factual inquiries necessitated by the annual State credit authority cap, the per-unit expenditure requirements, the certification of buyer income levels, the time limits on subsequent sales, and the recapture rules applicable to homebuyers, will tend to lead to additional disputes, including litigation, between the IRS and taxpayers. In addition, adding a new incentive to home ownership without coordinating with present-law incentives (such as the low-income housing credit), which have a similar policy goal but have somewhat different requirements, will cause a proliferation of similar provisions, adding to tax law complexity.

Policy issues

Families with incomes less than the median income family are less often homeowners than are families with incomes above the median income. While many factors determine a family's decision to rent rather than own their own home, the price of a home creates two important financial factors that, at least temporarily, persuade families with incomes less than the median income to choose to rent rather than buy. First, the greater the price of a home, the greater the required down payment, and families generally must accumulate funds for the down payment. Second, the greater the price of a home, the greater the monthly mortgage payment, and both lenders and prudent buyers generally limit monthly housing expenses by reference to a percentage of current income. In summary, lower housing prices will make it easier for families with incomes less than the median income to accumulate funds for a down payment and to qualify for a mortgage based upon their current income.

Supply and demand in the local housing market, determine the price of available homes. An important factor in determining the market price is the cost of developing new properties or renovating old properties. A developer's expenses in the provision of housing can be thought of as consisting of two components: (1) the cost of the land; and (2) the cost of construction. The proposal will provide a developer a credit against his income tax liability related to qualified construction expenses for housing sold to a qualified homebuyer whose family income is 80 percent or less of area median income (70 percent or less for families comprised of one, two, or three individuals). In a sale to a qualifying homebuyer, the credit has the effect of subsidizing construction costs. As a consequence, the developer may be able to offer housing for sale to a qualifying homebuyer at a lower price than the developer's costs, or the local housing market, might warrant. The tax credit may enable the developer to earn an after-tax rate of return comparable or greater to that the developer would have earned had the same housing been sold to a non-qualifying homebuyer or would have earned had the developer built other housing to be sold to a non-qualifying homebuyer in the same local housing market.

The statutory incidence of the proposal provides that the taxpayer developing the qualifying property claims the tax benefit. However, in a market economy the economic incidence can differ from the statutory incidence. All of the benefit can accrue to a buyer of the property in the form of reduction in purchase price (compared to an otherwise comparable home offered by a developer who has not received an allocation of the proposed tax credits) equal to the full present value of the tax credits[150] the developer/seller may claim under the proposal. Alternatively, there may be no change in purchase price (compared to an otherwise comparable

[150] The proposal will determine the present value of the tax credits as provided under present-law Code section 42 (the low-income housing credit). The present value calculation prescribed in subsection 42(b) was based on a marginal income tax rate applicable to the highest income taxpayers of 28 percent. Subsequent changes in the marginal income tax rate structure, including changes enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, have established marginal income tax rates other than 28 percent to be applicable to the highest income taxpayers. Thus, the present value calculation of the proposal may not reflect the actual present value to the taxpayer.

home offered by a developer who has not received an allocation of the proposed tax credits), in which case the entire economic benefit of the tax credits will accrue to the developer/seller claiming the credits under the proposal. Generally, the more responsive purchasers are to changes in the market price, the greater will be the proportion of the economic incidence of a tax benefit that accrues to the seller. The more responsive sellers are to changes in the market price, the greater will be the proportion of the economic incidence of a tax benefit that accrues to the purchaser.[151] For example, if there are relatively few properties of a comparable type and it is difficult to obtain land or building permits to build more such properties, the more likely it will be that qualifying homebuyers bid against one another for a property. By bidding up the sales price of the property, more of the economic benefit of the tax credit accrues to the seller. On the other hand, if there are relatively few qualified buyers, but there are several potential developers who have credit allocations and can easily supply housing for sale, the developers may compete against each other to sell to a qualifying buyer by lowering the price they charge to such buyers. By lowering the price of the property under competitive pressure, more of the economic benefit of the tax credit accrues to the buyer.

Because of the diversity in market conditions of different local housing markets, it is not possible to predict whether buyers or sellers are likely to be the primary economic beneficiary of the proposed tax credit. The proposal requires that the credit may only be claimed for sales that occur within one year of the property being certified for occupancy. The time limit may exert pressure on developers to reduce the price of the property in order to sell it before the one-year period expires. On the other hand, the limit on the number of properties on which the credit may be claimed may impose a supply constraint. Potential qualifying buyers can bid against one another, keeping the sales price higher than it otherwise might be. Even if the economic beneficiary were to be the developer, the developer may only claim the credit if a family with an income of less than 80 percent of the area median income is the purchaser. Therefore, even if such a family did not receive a substantial price discount, if the developer sold to such a family, rather than a non-qualifying family, the goal of increasing home ownership by families with incomes less than 80 percent of the area median income may have been advanced.

The proposal defines qualifying buyers by reference to their annual income at the time of purchase. As noted above, a lower proportion of families with incomes less than area median income are homeowners than are families with incomes above the area median income. It is also the case that families headed by individuals 30 years old or younger are more likely to have incomes less than the area median income than are families headed by individuals over 30 years of age. This arises because most individuals' earning power increases with experience and job tenure. As the family's earners age, the family is more able to accumulate funds for a down payment and have sufficient monthly income to qualify for a mortgage on a home. Data on homeownership by age are consistent with this scenario. In 2003, the percentage of household

[151] Economists measure the responsiveness to demand and supply to price changes by reference to the "price elasticity of demand" and the "price elasticity of supply." The greater the price elasticity of demand relative to the price elasticity of supply, the greater the economic incidence falls to the benefit of sellers. The greater the price elasticity of supply relative to the price elasticity of demand, the greater the economic incidence falls to the benefit of the buyer.

owner-occupiers among households headed by an individual less than 35 years old was 42.2 percent. The percentage of household owner-occupiers among households headed by an individual 35 to 44 years old was 68.3 percent. The percentage of household owner-occupiers among households headed by an individual 65 years old or older was 80.5 percent.[152] By targeting the credit based on annual income, the proposal may provide benefit to two distinct types of families. The proposal provides benefit both to those families whose income, year-in, year-out falls below 80 percent of area median and who, consequently, may otherwise always find down payment and monthly mortgage servicing requirements a hurdle to homeownership. The proposal also will provide a benefit to families whose income growth will permit them to own a home without assistance as the family's income grows through time. For such families the proposal may only accelerate their ultimate status as a homeowner.

Some observers may find some unfairness in the proposal's definition of qualifying family. Under the proposal, the Smith family, whose income is less than 80 percent of the area median income, and the Jones family, whose income is above 80 percent of the area median income, can bid on the same property. If the Smith family offered $95,000 for the property and the Jones family offered $100,000, under the proposal, the Smith's offer can dominate the Jones's offer on an after-tax basis to the seller. The Smith and Jones families can have very similar incomes. A modest raise may have pushed the Jones family above the qualifying income threshold and thereby denied the Jones family the opportunity to acquire the home or it may require the Jones family to offer even more if they hope to acquire the home.

Some opponents of the proposal question the necessity of providing additional benefits to homeownership. They note that homeownership rates are above 67 percent[153] and homeownership receives preferential treatment under the present income tax as mortgage interest, home equity interest, and property tax payments are deductible expenses and that for many taxpayers any capital gain on the income from the sale of a principal residence is excluded from income. In addition, they note that, under present law, States may issue qualified mortgage bonds and qualified mortgage credit certificates to lower the mortgage costs of middle and lower-middle income families who seek to acquire a home. That is, the qualified mortgage bond program and the qualified mortgage credit certificate program generally target the financial needs of the same population. Proponents of efforts to increase homeownership observe that homeownership helps support strong, vital communities and participatory democracy. In particular, they observe, the quality of life in distressed neighborhoods can be improved by increasing homeownership. In such neighborhoods the costs of renovation or new construction may exceed the current market value of housing in such neighborhoods and a State allocation mechanism for the proposed credits may be able to direct qualifying investments to such areas where the social return to homeownership is particularly large.

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[152] U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States: 2004-2005*.

[153] In 2003, of 105.9 million occupied housing units nationwide, 72.3 million, or 68.2 percent were owner-occupied. U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States: 2004- 2005*.

Prior Action

A similar proposal was included in the President's fiscal year 2002, 2003, 2004, and 2005 budget proposals.

I. Environment and Conservation Related Provisions

1. Permanently extend expensing of brownfields remediation costs

Present Law

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

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[154] and section 263A, are treated as qualified environmental remediation expenditures.

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

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

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

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

Description of Proposal

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

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

Analysis

Policy issues

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

The proposal is intended to encourage environmental remediation, and general business investment, at contaminated sites. With respect to environmental remediation tax benefits as an incentive for general business investment, it is possible that the incentive may have the effect of distorting the location of new investment, rather than increasing investment overall.[155] If the new investments are offset by less investment in neighboring, but not qualifying, areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

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

Complexity issues

By making the present law provision permanent, the proposal may simplify tax planning and investment planning by taxpayers by providing more certainty. However, in general, the proposal would treat expenditures at certain geographic locations differently from otherwise identical expenditures at other geographic locations. Such distinctions generally require additional record keeping on the part of taxpayers and more complex tax return filings. Concomitantly, such distinctions increase the difficulty of IRS audits.

Prior Action

Proposals to make section 198 permanent were included in the President's fiscal year 1999, 2000, 2001, 2002, 2003, 2004, and 2005 budget proposals.

2. Exclude 50 percent of gains from the sale of property for conservation purposes

Present Law

Income tax treatment of dispositions of land

Capital gains treatment

In general, gain or loss reflected in the value of an asset is recognized for income tax purposes at the time the taxpayer disposes of the property. On the sale or exchange of capital assets held for more than one year, gain generally is taxed to an individual taxpayer at a maximum marginal rate of 15 percent. However, gain attributable to real estate depreciation deductions that were previously claimed against ordinary income is taxed at a maximum marginal rate of 25 percent. Losses from the sale or exchange of capital assets are deductible only to the extent of the gains from the sale or exchange of other capital assets, plus, in the case of individuals, $3,000.

Land is a capital asset, unless it is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or it is used in the taxpayer's trade or business. In addition, if the gains from property, including land, used in a taxpayer's trade or business exceed the losses from such property, the gains and losses are treated as capital gains.

Deferral of gain or loss

Several provisions allow a taxpayer to defer gain when property, including land, is disposed of. For example, gain or loss is deferred if land held for investment or business use is exchanged for property of a like kind (generally defined to include other real estate) (sec. 1031). Likewise, gain is deferred if land is condemned and replaced with other property of a like kind (sec. 1033(g)).

Income tax provisions relating to contributions of capital gain property and qualified conservation interests

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (secs. 170, 2055, and 2522 respectively).

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible generally is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed.

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally is not allowable as a charitable deduction unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund.

Capital gain property

Capital gain property is property, which if sold at fair market value at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined

as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of a historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryforward rules applicable to other charitable contributions of capital gain property.

Description of Proposal

The proposal provides that a taxpayer may exclude from income 50 percent of the gain realized from the sale of land (or an interest in land or water) to a qualified conservation organization for conservation purposes. The income not excluded is taxed as capital gain eligible for the alternative rate schedule of present law. The exclusion is computed without regard to improvements.

To be eligible for the exclusion, the taxpayer or a member of the taxpayer's family has to have owned the property for the three years immediately preceding the date of the sale. The taxpayer is not eligible for the exclusion in the case of property sold pursuant to a condemnation order, but the taxpayer is eligible for the exclusion in the case of property sold in response to the threat or imminence of a condemnation order.

A qualified conservation organization is either a governmental unit or a charity that is a qualified organization under present-law section 170(h)(3) and that is organized and operated primarily for conservation purposes. Conservation purposes include the preservation of land areas for outdoor recreation by, or the education of, the general public; the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or the preservation of open space where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy.

The buyer must provide a written statement representing that it is a qualified conservation organization and that it intends to hold the property exclusively for conservation purposes and not to transfer it for valuable consideration other than to a qualified conservation organization in a transaction that would qualify under the proposal if the qualified conservation organization (i.e., the buyer in the transaction that is the subject of the written statement) were a taxable person.

Sales of partial interests in property also qualify if the sale meets the present law standards for qualified conservation contributions of partial interests within the meaning of section 170(h).

To prevent abuse, significant penalties are imposed on any subsequent transfer or use of the property other than exclusively for conservation purposes, or on any subsequent removal of a conservation restriction contained in an instrument of conveyance of the property. Sales of the property under the proposal at a price that is less than the fair market value of property qualify as bargain sales,[156] but only to the extent that the proceeds of the sale, net of capital gains taxes under this provision, are lower than the after-tax proceeds that would have resulted if the property had been sold at fair market value and the seller had paid tax on the full amount of the resulting gain.

Effective date.–The proposal is effective for sales occurring on or after January 1, 2006, and before January 1, 2009.

Analysis

Policy issues

In general, for sales of real estate, the maximum tax rate applied to capital gain income (excluding improvements) is 15 percent for taxpayers who would otherwise be in the 25 percent, 28 percent, 33 percent, and 35 percent ordinary income tax brackets.[157] If such a taxpayer sold conservation property to a qualifying conservation organization, after the 50-percent exclusion, the effective tax rate on the gain income would be 7.5 percent.[158] Per $1,000 of gain, the proposal could produce a benefit of up to $75 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price.[159] The proposal seeks to increase sales of conservation property to qualifying conservation organizations by making it possible for the seller to reap a higher after-tax return by selling property to the qualifying conservation organization than by selling to a non-qualifying buyer.

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[156] See Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

[157] Under present law, the maximum tax rate applied to capital gain income for taxpayers in the 10 and 15-percent income tax brackets is five percent (zero percent after 2007).

[158] In the case of a taxpayer otherwise in the 10-percent or 15-percent marginal income tax bracket, the result of the combination of the exclusion and the alternative five-percent tax rate on income from capital gain is an effective tax rate of 2.5 percent on the gain.

[159] In the case of a taxpayer otherwise in the 10-percent or 15-percent marginal income tax brackets, per $1,000 of gain, the proposal could produce a benefit of up to $25 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price.

The simple calculations above may suggest that the seller would reap the full benefit of the lower effective tax rate. However, qualifying conservation organizations, recognizing that their purchase of property can qualify a taxpayer for a lower effective tax rate (a higher after-tax return) may bid less than they otherwise might knowing that the highest offer may not be selected by a taxpayer who is informed of the tax benefits of the lower bid. In this sense, the proposal is equivalent to the Federal government partially subsidizing the purchase of conservation property selected by the qualifying conservation organization. From the calculations above, by lowering the effective tax rate, the Federal government would be effectively contributing as much as 7.5 percent of the purchase price of the property.[160]

The extent to which the benefit of the proposed exclusion accrues to the taxpayer selling the property or to the qualifying conservation organization purchasing the property depends upon the demand for the property and the extent to which other similar properties also are offered for sale. If one qualifying conservation organization is bidding against other persons for a property, in general one might expect that the qualifying conservation organization might be able to derive a substantial portion of the benefit of the lower effective tax rate. While the persons who are not qualifying conservation organizations would bid based on what they believe the market value of the property to be, the qualifying conservation could bid less, and as demonstrated above, the seller could find it in his or her interest to accept the lower bid of the qualifying conservation organization. To receive the entire benefit of the lower effective tax rate, the qualifying conservation organization would have to know the tax position of the seller (see discussion of complexity below). In practice, such knowledge would not be available to the qualifying conservation organization and conservative bidding would result in the qualifying conservation organization deriving less than the full benefit.

On the other hand, if several qualifying conservation organizations bid against each other on the same property, as they compete with price offers they would transfer most of the benefit from the exclusion to the taxpayer selling the property.

The incentive effects of the proposal decrease as the capital gains tax rate decreases for the selling taxpayer, as is the case for many taxpayers as a result of the JGTRRA capital gain rate reductions.

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[160] The percentages in the text assume that the taxpayer selling the property has a zero basis in the property. Thus, the percentages in the text represent an upper bound on the Federal government's effective share of the purchase price. In the case of property sold by a taxpayer otherwise in the 10- or 15-percent marginal income tax brackets, the comparable percentages would be lower.

Complexity issues

In its report,[161] the staff of the Joint Committee on Taxation identified the taxation of income from capital gains as an area of complexity in the individual income tax. The staff of the Joint Committee on Taxation has identified nine different categories of capital gain, often with multiple rates of tax applying within each category depending upon the taxpayer's circumstance. Present law requires a holding period of one year or more for a taxpayer to avail him or herself of the benefit of the alternative tax rates applicable to capital gain income. The proposal layers an exclusion for the sale of certain assets on top of the present law alternative rate schedule. The proposal would create a new three-year holding period requirement. This would require additional computation, instructions, and a longer form for individuals who recognize gains that qualify for the exclusion of the proposal and also have other gain income. While relatively few taxpayers would recognize qualifying gains in any one year, those taxpayers who recognize other capital gain income will have a more complex form to work through.

By its design, the proposal makes economic decisions more complicated as a taxpayer's net rate of return to the sale of property would depend upon the buyer's identity as well as the buyer's purchase offer. In theory, if the proposal were to have the desired incentive effect, the taxpayer would weigh the offer price of a qualifying conservation organization against competing offers from other persons by calculating his or her after-tax position. Such calculations are more complex than comparing the dollar purchase offers of competing buyers. From the buyer's side, if the qualifying conservation organization were to attempt to utilize the proposal to its benefit by offering a lower price to the seller, the organization would have to make estimates, or consult with the seller, regarding the seller's tax position for the year of the sale. This would include researching whether the seller's effective rate of tax may be less than 7.5 percent. As accurate estimates might be crucial to submitting a winning offer for qualifying property, the qualifying conservation organization, in principle, would need to have information about the financial affairs of the seller. Such an offer strategy is a more information intensive process than typical real estate transactions.

The proposal imposes an additional paperwork and record keeping burden on the qualifying conservation organization and the selling taxpayer. The qualifying conservation organization must provide certification to the taxpayer selling the property that the sale and purchase is a qualifying conservation transaction. The selling taxpayer must retain this certification in order to claim the exclusion. Presumably, a separate reporting requirement would be established for the buyer and or seller to notify the IRS of a qualifying sale. As the holding period of potentially qualifying property is satisfied by reference to the taxpayer's family, rather than solely by reference to the taxpayer's ownership of the property, in some cases documentation from other persons also would be required.

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[161] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, at 97-108, (JCS-3-01), April 2001.

The proposal also imposes additional complexity and record keeping burdens on the qualifying conservation organization because of the potential penalties that may be imposed for subsequent transfers or uses of the property that do not satisfy the conservation requirements. The organization likely will be required to retain records that demonstrate compliance with the proposal's requirements, and to notify the IRS if any impermissible change in use takes place with respect to the property. The IRS will have to modify its forms and instructions to provide for the imposition of the penalties in such cases. The application of modified bargain-sale rules to qualified conservation sales at a price less than fair market value also increases complexity for the buyer and seller of the property.

Prior Action

A similar proposal was included in the President's fiscal year 2002 and 2003 budget proposals, which included less detail regarding the penalty and bargain-sale provisions, and in the President's fiscal year 2004 and 2005 budget proposals.

A similar proposal was included in section 107 of S. 476, the "CARE Act of 2003," passed by the Senate on April 9, 2003, which would exclude 25 percent of long-term capital gain on certain sales or exchanges to eligible entities for conservation purposes.

J. Energy Provisions

1. Extend and modify the tax credit for producing electricity from certain sources

Present Law[162]

In general

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

Credit amounts and credit period

In general

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

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

Reduced credit amounts and credit periods

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

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

Credit applicable to refined coal

The amount of the credit for refined coal is $4.375 per ton (also indexed for inflation after 2002 and would have equaled $5.350 per ton for 2004).

Other limitations on credit claimants and credit amounts

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

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

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)).

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

Qualified facilities

Wind energy facility

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

Closed-loop biomass facility

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

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

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

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

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

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

Geothermal facility

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

Solar facility

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

Small irrigation facility

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is not less than 150 kilowatts and less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after the date of enactment and before January 1, 2006.

Landfill gas facility

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

Trash combustion facility

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

Refined coal facility

A qualifying refined coal facility is a facility producing refined coal that is placed in service after the date of enactment and before January 1, 2009. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxides and either SO_2 or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal the fuel must be sold by the taxpayer with the reasonable expectation that it will be used for the primary purpose of producing steam.

Description of Proposal

The proposal extends the placed in service date for facilities that produce electricity from wind, closed-loop biomass, open-loop biomass (other than agricultural waste nutrients), and landfill gas to include electricity from those facilities placed in service before January 1, 2008.[163] The proposal does not extend the placed in service date for facilities that produce electricity from agricultural waste nutrient facilities, geothermal facilities, solar power facilities, small irrigation facilities, or trash combustion facilities.

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

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

Analysis

See the general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

The President's fiscal year 2005, 2004 and 2003 budgets proposed a similar proposal to the current proposal. The President's fiscal year 2001 and 2002 budgets also proposed extending and modifying the categories of facilities that would qualify for the production credit under section 45.

2. Provide a tax credit for residential solar energy systems

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the

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

taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law personal tax credit for residential solar energy property.

Description of Proposal

The proposal provides a tax credit for the purchase of photovoltaic equipment and solar water heating equipment for use in a dwelling unit that is used by the taxpayer as a residence. Equipment would qualify for the credit only if is used exclusively for purposes other than heating swimming pools. The credit is equal to 15 percent of qualified investment up to a cumulative maximum of $2,000 for solar water heating systems and $2,000 for rooftop photovoltaic systems. This credit is nonrefundable.

Effective date.–The credit applies to equipment placed in service after December 31, 2004 and before January 1, 2008 for solar water heating systems and after December 31, 2004 and before January 1, 2010 for photovoltaic systems.

Analysis

See general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

Similar proposals were contained in the President's fiscal year 1999-2005 budget proposals.

A similar provision was contained in H.R. 4520, the “Jumpstart Our Business Strength Act, as amended and passed by the Senate on July 15, 2004, and in S. 1637, the “Jumpstart Our Business Strength Act, as passed by the Senate on May 11, 2004.

The conference agreement to H.R. 6, “The Energy Policy Act of 2003,” as passed by the House of Representatives on November 18, 2003 contained a similar provision. Similar provisions are contained in Division D of H.R. 6, the “Energy Tax Policy Act of 2003,” as passed by the House of Representatives on April 11, 2003, and in Division H of H.R. 6, the “Energy Tax Incentives Act of 2003” as amended and passed by the Senate on July 31, 2003.

Similar provisions were also contained in Division C of H.R. 4, the “Energy Tax Policy Act of 2001,” as passed by the House of Representatives on August 2, 2001, and in Division H

of H.R. 4, "The Energy Tax Incentives Act of 2002," as amended and passed by the Senate on April 25, 2002.

3. Modify the tax treatment of nuclear decommissioning funds

Present Law

Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act"), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a "qualified fund") is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[164]

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the "cost of service requirement").[165] Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1983 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant's

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[164] As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

[165] Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the "ruling amount"). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[166] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[167]

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[168] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund's owner as it is earned.

Description of Proposal

Repeal of cost of service requirement

The proposal repeals the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified fund.

Exception to ruling amount for certain decommissioning costs

The proposal also permits taxpayers to make contributions to a qualified fund in excess of the maximum annual contribution amount (IRS ruling amount) up to an amount that equals the

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[166] Treas. Reg. sec. 1.468A-6.

[167] Treas. Reg. sec. 1.468A-6(f).

[168] These funds are generally referred to as "nonqualified funds."

present value of the amount required to fund the nuclear powerplant's pre-1984 decommissioning costs to which the qualified fund relates. Any amount transferred to the qualified fund that has not previously been deducted or excluded from gross income is allowed as a deduction over the remaining useful life of the nuclear powerplant. If a qualified fund that has received amounts under this rule is transferred to another person, that person will be entitled to the deduction at the same time and in the same manner as the transferor. Accordingly, if the transferor was not subject to tax and thus unable to use the deduction, then the transferee will similarly not be able to utilize the deduction. Amounts contributed (and the earnings on such amounts) under these rules would not be taken into account in determining the ruling amount for the qualified fund.

Clarify treatment of transfers of qualified funds and deductibility of decommissioning costs

The proposal clarifies the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established. In addition, the proposal provides that all nuclear decommissioning costs are deductible when paid.

Contributions to a qualified fund after useful life of powerplant

The proposal also allows deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments are permitted to the extent they do not cause the assets of the qualified fund to exceed the present value of the taxpayer's allocable share (current or former) of the nuclear decommissioning costs of such nuclear powerplant.

Effective date

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

Analysis

Policy issues

The cost of service limitation on the amount of deductible contributions to a qualified nuclear decommissioning fund reflects the regulatory environment that existed when the legislation was originally enacted in 1984 and all taxable entities producing nuclear power were subject to rate regulation. More recently, the process of deregulating the electric power industry has begun at both the Federal and state level. Proponents of the proposal argue that the present-law limitation is outdated, and that the rules relating to deductible contributions to nuclear decommissioning funds should be modernized to reflect industry deregulation.

The process of deregulation takes different forms in different jurisdictions. A jurisdiction may choose to eliminate rate regulation and allow rates to be set by the market instead of the public utility commission. Although such market rates may include an element compensating a generator of nuclear power for its anticipated decommissioning costs, there is no regulatory cost of service amount against which to measure a deductible contribution. A line charge or other fee

could be imposed by a State or local government or a public utility commission to ensure that adequate funds will be available for decommissioning, but there is no assurance that this will be the case. The taxpayer generating the electricity may not be the same as the taxpayer distributing it. In those cases, the use of line charges and other customer based fees as a vehicle to satisfy the requirement that deductible contributions not exceed cost of service may not be successful.

The exception allowing a taxpayer responsible for nuclear power plant decommissioning to deduct contributions to a qualified nuclear decommissioning fund for future payment costs was enacted in Congress' belief that the establishment of segregated reserve funds for paying future nuclear decommissioning costs was of national importance.[169] If deregulation continues, the deduction of such contributions may be prevented unless the cost of service limitation is repealed. The loss of deductibility may reduce the amount of funds available for decommissioning in the future.

In addition, the proposal allows taxpayers to transfer to a qualified fund decommissioning costs for the period prior to the qualified fund's existence (generally pre-1984 decommissioning costs of a nuclear powerplant). Proponents of this aspect of the proposal argue that it provides equal treatment to all decommissioning costs and provides an incentive for taxpayers to ensure that sufficient funds are being reserved for decommissioning costs. However, some may argue that safeguards are already in place that require funds to be available for decommissioning and that this aspect of the proposal merely reduces the effective tax rate on earnings associated with the reserved funds. Finally, clarifying the treatment of transfers of qualified funds removes a tax barrier that may be hindering taxpayers from fulfilling various policy goals of electricity deregulation.

Complexity issues

Many aspects of the proposal provide clarification to issues that would simplify the administration of the present-law provision and likely reduce the cost of complying with the tax law and minimize disputes between taxpayers and the IRS.

Prior Action

A similar proposal was included in the President's fiscal year 2003, 2004, and 2005 budget proposals. Similar proposals were also included in section 1328 of the Conference Report to H.R. 6, the "Energy Policy Act of 2003," and section 855 of the Senate Amendment to H.R. 4520, the "American Jobs Creation Act of 2004."

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[169] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, p. 270.

4. Provide a tax credit for purchase of the certain hybrid and fuel cell vehicles

Present Law[170]

Credit for qualified electric vehicles

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. A qualified electric vehicle generally is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The full amount of the credit is available for purchases prior to 2006. The credit is reduced to 25 percent of the otherwise allowable amount for purchases in 2006, and is unavailable for purchases after December 31, 2006.

Deduction for qualified clean-fuel vehicle property

Qualified clean-fuel vehicles

Certain costs of qualified clean-fuel vehicle may be expensed and deducted when such property is placed in service. Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The Secretary has determined that certain hybrid (gas-electric) vehicles are qualified clean-fuel vehicles.

The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. The deduction allowable for purchases of vehicles in 2006 is 25 percent of the otherwise allowable amount, and is unavailable for purchases after December 31, 2006.

Refueling property

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. Expensing for clean-fuel vehicle refueling property is unavailable for expenditures after December 31, 2006.

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[170] Code sections 30 and 179A were enacted as part of the Energy Policy Act of 1992 and were extended by the Job Creation and Worker Assistance Act of 2002.

Description of Proposal

In general

The proposal provides a tax credit for the purchase of a qualified hybrid vehicle or fuel cell vehicle purchased after December 31, 2004, and before January 1, 2009, for a hybrid vehicle and after December 31, 2004, and before January 1, 2013, for a fuel cell vehicle. The credits are available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers are eligible for only one of the credits per vehicle and taxpayers who claim either credit are not eligible for the qualified electric vehicle credit or the deduction for clean-fuel vehicles for the same vehicle. For business taxpayers the credit is part of the general business credit and the taxpayer will reduce his or her basis in the vehicle by the amount of the credit. A qualifying vehicle must meet all applicable regulatory requirements for safety and air pollutants.

Hybrid vehicles

A qualifying hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (*e.g.*, batteries). The amount of credit for the purchase of a hybrid vehicle is the sum of two components, a base credit amount that varies with the amount of power available from the rechargeable storage system and a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2000 model year standard. Table 2, below, shows the proposed base credit amounts.

Table 2.–Hybrid Vehicle Base Credit Amount Dependent Upon the Power Available from the Rechargeable Energy Storage System As a Percentage of the Vehicles Maximum Available Power

Base Credit Amount	If Rechargeable Energy Storages System Provides:	
	at least	but less than
$250	5% of maximum available power	10% of maximum available power
$500	10% of maximum available power	20% of maximum available power
$750	20% of maximum available power	30% of maximum available power
$1,000	30% or greater of maximum available power	

For these purposes, a vehicle's power available from its rechargeable energy storage system as a percentage of maximum available power is calculated as the maximum value available from the battery or other energy storage device during a standard power test, divided by the sum of the battery or other energy storage device and the SAE net power of the heat engine.

Table 3, below, shows the proposed additional fuel economy credit available to hybrid vehicles whose fuel economy exceeds that of a base fuel economy. For these purposes the base

fuel economy is the 2000 model year city fuel economy rating for vehicles of various weight classes (see below).

Table 3.–Additional Fuel Economy Credit for Hybrid Vehicles

Credit	If Fuel Economy of the Hybrid Vehicle Is:	
	at least	but less than
$500	125% of base fuel economy	150% of base fuel economy
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% or greater of base fuel economy	

Fuel cell vehicles

A qualifying fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. The amount of credit for the purchase of a fuel cell vehicle is $4,000 plus an additional credit determined by the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2000 model year city fuel economy rating for vehicles of various weight classes (see below). Table 4, below, shows the proposed credits for qualifying fuel cell vehicles.

Table 4.–Additional Fuel Economy Credit for Fuel Cell Vehicles

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	at least	But less than
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	275% of base fuel economy
$3,500	275% of base fuel economy	300% of base fuel economy
$4,000	300% or greater of base fuel economy	

Base fuel economy

The base fuel economy is the 2000 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 5, below, shows the 2000 model year city fuel economy for vehicles by type and by inertia weight class.

Table 5.–2000 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	43.7	37.6
1,750	43.7	37.6
2,000	38.3	33.7
2,250	34.1	30.6
2,500	30.7	28.0
2,750	27.9	25.9
3,000	25.6	24.1
3,500	22.0	21.3
4,000	19.3	19.0
4,500	17.2	17.3
5,000	15.5	15.8
5,500	14.1	14.6
6,000	12.9	13.6
6,500	11.9	12.8
7,000	11.1	12.0
8,500	11.1	12.0

Effective date.–The proposal is effective for vehicles purchased after December 31, 2004.

Analysis

See the general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

The President's fiscal year 2003, 2004, and 2005 budget proposals contained a similar proposal to the current proposal (identical except for effective dates). The President's fiscal year 1999, 2000, 2001, and 2002 budget proposals proposed creating a credit for electric and hybrid vehicles.

5. Provide a tax credit for combined heat and power property

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

Description of Proposal

The proposal would establish a 10-percent investment credit for qualified CHP systems with an electrical capacity in excess of 50 kilowatts or with a capacity to produce mechanical power in excess of 67 horsepower (or an equivalent combination of electrical and mechanical energy capacities). CHP property is defined as property comprising a system that uses the same energy source for the simultaneous or sequential generation of (1) electricity or mechanical shaft power (or both) and (2) steam or other forms of useful thermal energy (including heating and cooling applications). A qualified CHP system is required to produce at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof) and would also be required to satisfy an energy-efficiency standard. For CHP systems with an electrical capacity in excess of 50 megawatts (or a mechanical energy capacity in excess of 67,000 horsepower), the total energy efficiency of the system would have to exceed 70 percent. For smaller systems, the total energy efficiency would have to exceed 60 percent. For this purpose, total energy efficiency

is calculated as the sum of the useful electrical, thermal, and mechanical power produced by the system at normal operating rates, measured on a Btu basis, divided by the lower heating value of the primary fuel source for the system. The eligibility of qualified CHP property is verified under regulations prescribed by the Secretary of the Treasury.

Qualified CHP assets that are assigned cost recovery periods of less than 15 years are eligible for the credit, but only if the taxpayer elects to treat such property as having a 22-year class life. Thus, for such property, regular tax depreciation allowances are calculated using a 15-year recovery period and the 150 percent declining balance method.

The credit is treated as an energy credit under the investment credit component of the section 38 general business credit, and is subject to the rules and limitations governing that credit. Taxpayers using the credit for CHP equipment would not be entitled to any other tax credit for the same equipment.

Effective date.–The credit would apply to property placed in service after December 31, 2004 and before January 1, 2010.

Analysis

See general discussion immediately below.

Prior Action

A similar proposal was contained in the President's fiscal year 2000 through 2005 budget proposals.

A similar provision was contained in H.R. 4520, the "Jumpstart Our Business Strength Act, as amended and passed by the Senate on July 15, 2004, and in S. 1637, the "Jumpstart Our Business Strength Act, as passed by the Senate on May 11, 2004.

The conference agreement to H.R. 6, "The Energy Policy Act of 2003," as passed by the House of Representatives on November 18, 2003, contained a similar provision. Similar provisions are contained in Division D of H.R. 6, the "Energy Tax Policy Act of 2003," as passed by the House of Representatives on April 11, 2003, and in Division H of H.R. 6, the "Energy Tax Incentives Act of 2003" as amended and passed by the Senate on July 31, 2003.

Similar provisions were also contained in Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and in Division H of H.R. 4, "The Energy Tax Incentives Act of 2002," as amended and passed by the Senate on April 25, 2002.

Analysis for 1, 2, 4, and 5.

General rationale for tax benefits for energy conservation and pollution abatement

The general rationale for providing tax benefits to energy conservation and pollution abatement is that there exist externalities in the consumption or production of certain goods. An

externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole. When the social costs of consumption exceed the private costs of consumption, a negative externality exists. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over-consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under consumption or production of the good producing the positive externality. The reason for the over consumption or under consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption or production, because in this case private costs and benefits will be equal to social costs and benefits.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are two possible government interventions that could produce a more socially desirable level of pollution. One such approach would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. An alternative approach would be to employ a system of payments, such as perhaps tax credits, to essentially pay polluters to reduce pollution. If the payments can be set in such a way as to yield the right amount of reduction (that is, without paying for reduction more than the reduction is valued, or failing to pay for a reduction where the payment would be less than the value of the pollution reduction), the socially desirable level of pollution will result. The basic difference between these two approaches is a question of who pays for the pollution reduction. The tax approach suggests that the right to clean air is paramount to the right to pollute, as polluters would bear the social costs of their pollution. The alternative approach suggests that the pollution reduction costs should be borne by those who receive the benefit of the reduction.

In the case of a positive externality, the appropriate economic policy would be to impose a negative tax (i.e., a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production.

Targeted investment tax credits

Three of the proposals related to energy and the environment (residential solar, combined heat and power, and hybrid vehicles) are targeted investment tax credits designed to encourage investment in certain assets that reduce the consumption of conventional fuels and that reduce

the emissions of gases related to atmospheric warming and other pollutants. The following general analysis of targeted investment tax credits is applicable to these proposals.

As a general matter of economic efficiency, tax credits designed to influence investment choices should be used only when it is acknowledged that market-based pricing signals have led to a lower level of investment in a good than would be socially optimal. In general, this can occur in a market-based economy when private investors do not capture the full value of an investment–that is, when there are positive externalities to the investment that accrue to third parties who did not bear any of the costs of the investments. For example, if an individual or corporation can borrow funds at 10 percent and make an investment that will return 15 percent, they will generally make that investment. However, if the return were 15 percent, but only eight percent of that return went to the investor, and seven percent to third parties, the investment will generally not take place, even though the social return (the sum of the return to the investor and other parties) would indicate that the investment should be made. In such a situation, it may be desirable to subsidize the return to the investor through tax credits or other mechanisms in order that the investor's return is sufficient to cause the socially desirable investment to be made. In this example, a credit that raised the return to the investor to at least 10 percent would be necessary. Even if the cost of the credit led to tax increases for the third parties, they would presumably be better off since they enjoy a seven-percent return from the investment, and the credit would only need to raise the return to the investor by two percent for him or her to break even. Thus, even if the third parties would bear the full cost of the credit, they would, on net, enjoy a five-percent return to the investment (seven percent less two percent).

There are certain aspects of targeted tax credits that could impair the efficiency with which they achieve the desired goal of reduced atmospheric emissions. By targeting only certain investments, other more cost-effective means of pollution reduction may be overlooked. Many economists would argue that the most efficient means of addressing pollution would be through a direct tax on the pollution-causing activities, rather than through the indirect approach of targeted tax credits for certain technologies. By this approach, the establishment of the economically efficient prices on pollutants, through taxes, would result in the socially optimal level of pollution. This would indirectly lead to the adoption of the types of technologies favored in the President's budget, but only if they were in fact the most socially efficient technologies. In many cases, however, establishing the right prices on pollution-causing activities through taxes could be administratively infeasible, and other solutions such as targeted credits may be more appropriate.

A second potential inefficiency of investment tax credits is one of budgetary inefficiency, in the sense that their budgetary costs could be large relative to the incremental investment in the targeted activities. The reason for this is that there will generally have been investment in the activities eligible for the credit even in the absence of the credit. Thus, for example, if investors planned to invest a million dollars in an activity before a 10-percent credit, and the credit caused the investment to rise $100,000 to $1.1 million because of the credit, then only $100,000 in additional investment can be attributed to the credit. However, all $1.1 million in investments will be eligible for the 10-percent credit, at a budgetary cost of $110,000 (10 percent of 1.1 million). Thus, only $100,000 in additional investment would be undertaken, at a budgetary cost of $110,000. Because there is a large aggregate amount of investment undertaken without

general investment credits, introducing a general credit would subsidize much activity that would have taken place anyway.

Targeted credits like the above proposals, on the other hand, are likely to be more cost effective, from a budget perspective, in achieving the objective of increased investment, if only for the reason that a government would likely not consider their use if there were already extensive investment in a given area. Thus, not much investment that would take place anyhow is subsidized, because there presumably is not much of such investment taking place. The presumption behind these targeted tax credits is that there is not sufficient investment in the targeted areas because the alternative and more emissions-producing investments are less costly to the investor. Hence, a tax credit would be necessary to reduce costs and encourage investment in the favored activity.

A final limitation on the efficiency of the proposed credits is their restricted availability. The proposed tax credits come with several limitations beyond their stipulated dollar limitation. Specifically, they are nonrefundable and cannot be used to offset tax liability determined under the AMT.[171] The credit for solar equipment has a cap on the dollar amount of the credit, and thus after the cap is reached the marginal cost of further investment becomes equal to the market price again, which is presumed to be inefficient. The impact of these limitations is to make the credit less valuable to those without sufficient tax liability to claim the full credit, for those subject to the AMT, or those who have reached any cap on the credit. Given the arguments outlined above as to the rationale for targeted tax credits, it is not economically efficient to limit their availability based on the tax status of a possible user of the credit. It can be argued that, if such social benefits exist and are best achieved through the tax system, the credit should be both refundable and available to AMT taxpayers. Some would argue that making the credits refundable may introduce compliance problems that would exceed the benefits from encouraging the targeted activities for the populations lacking sufficient tax liability to make use of the credit. With respect to the AMT, the rationale for the limitation is to protect the objective of the AMT, which is to insure that all taxpayers pay a minimum (determined by the AMT) amount of tax. Two differing policy goals thus come in conflict in this instance. Similarly, caps on the aggregate amount of a credit that a taxpayer may claim are presumably designed to limit the credit's use out of some sense of fairness, but again, this conflicts with the goal of pollution reduction.

A justification for targeted tax credits that has been offered with respect to some pollution abatement activities, such as home improvements that would produce energy savings (installation of energy saving light bulbs or attic insulation, for example), is that the investment is economically sound at unsubsidized prices, but that homeowners or business owners are unaware of the high returns to the investments. The argument for targeted tax credits in this case is that they are needed to raise the awareness of the homeowner, or to lower the price sufficiently to convince the homeowner that the investment is worthwhile, even though the investment is in their interest even without the subsidy. These arguments have been called into

[171] The AMT treatment of the proposed personal credits for residential solar and hybrid vehicles is unclear. The proposals do not state that the credits would be allowed to offset AMT liability.

question recently on the grounds that the returns to the investments have been overstated by manufacturers, or are achievable only under ideal circumstances. This view holds that the returns to these investments are not dissimilar to other investments of similar risk profile, and that homeowners have not been economically irrational in their willingness to undertake certain energy saving investments. Of course, to the extent that there are negative externalities from the private energy consumption, these households, though making rational private choices, will not make the most socially beneficial choices without some form of subsidy.

A final justification offered for targeted tax credits in some instances is to "jump start" demand in certain infant industries in the hopes that over time the price of such goods will fall as the rewards from competition and scale economies in production are reaped. However, there is no guarantee that the infant industry would ultimately become viable without continued subsidies. This argument is often offered for production of electric cars–that if the demand is sufficient the production costs will fall enough to make them ultimately viable without subsidies. This justification is consistent with the current proposals in that the credits are available only for a limited period of time.

Production tax credits

One of the proposals related to energy and the environment (the credit for electricity produced from wind, biomass, and landfill gas) is a production tax credit. This type of credit differs from an investment tax credit in that the credit amount is based on production, rather than on investment. Some argue that a production credit provides for a stream of tax benefits, rather than an up-front lump sum, and that the stream of benefits can help provide financing for investment projects. On the other hand, an up-front tax credit provides more certainty, as the future production credits could possibly be curtailed by future Congresses. In general, investors prefer certainty to uncertainty, and thus may discount the value of future production credits. Another difference between a production credit and an investment credit is that the latter provides only a temporary distortion to the market–once the investment is made, normal competitive market conditions will prevail and the rational firm will only produce its end product if it can cover its variable costs. With a production credit, a firm may actually profitably produce even though it cannot cover its variable costs in the absence of the credit. This would generally be considered an economically inefficient outcome unless there are positive externalities to the production of the good that exceed the value of the credit. In the case of electricity produced from wind or biomass, if it is presumed that the electricity produced from these sources substitutes for electricity produced from the burning of fossil fuels, economic efficiency will be improved so long as the credit does not have to be set so high in order to encourage the alternative production that it exceeds the value of the positive externality. On the other hand, by making some production of electricity cheaper, it is possible that the credit could encourage more electricity consumption. On net, however, there would be less electricity produced from fossil fuels.

With respect to the increase in the credit rate for open-loop biomass, the basic issues are the same as those outlined above for any tax benefit for energy conservation or pollution abatement. To justify the credit on economic grounds, the positive externalities from the burning of biomass for the production of electricity must outweigh the costs of the tax subsidy. One positive externality is similar to that of wind power production, namely the reduction in

electricity production from the more environmentally damaging coal. Another consideration with the waste products is whether their current disposal is harmful to the environment. If so, an additional positive externality may exist from discouraging such disposal. If the disposal is harmful to the environment and is a partial justification for the credit, then ideally the credit amount should vary for each biomass waste product if their present disposal varies in its harm to the environment. A single credit rate would be justified if the negative externalities are of a similar magnitude, or if administrative considerations would make multiple credit rates problematic.

Complexity issues

Each of the President's proposals in the area of energy production and conservation can be expected to increase the complexity of tax law. Though the effect of each provision, or even all provisions collectively, on tax law complexity may be small, they would all add to complexity merely by providing new tax benefits not previously available. Taxpayers considering using these provisions would need to consider the impact of additional tax factors in making investment decisions, and taxpayers that actually utilize the provisions will need to educate themselves as to the rules of the provisions, as well as fill out the necessary forms to claim the tax benefits. Taxpayers constrained by the AMT or by the nonrefundability of the credit would face additional complications in determining the value of the various credits to them, which would further complicate their investment choices.

In general, the proposal related to the production tax credits adds less complexity in the aggregate as it is mainly an extension of present law, and there are relatively few taxpayers in a position to claim such benefits. The personal credits, such as those for solar equipment and hybrid vehicles, add more aggregate complexity as they would be new credits. Many taxpayers would be able to avail themselves of the credit and the credits could induce millions more to at least consider purchasing hybrid vehicles or solar equipment as a result of the credit.

K. Restructure Assistance to New York

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[172]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.[173] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[174] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ

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[172] In addition to the NYLZ provisions described above, other NYLZ incentives are provided: (1) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property is authorized to be issued after March 9, 2002, and before January 1, 2010; and (2) $9 billion of additional tax-exempt advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

[173] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

[174] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

leasehold improvement property[175] and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[176] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.[177]

Nonresidential real property and residential rental property is eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[178] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Depreciation of New York Liberty Zone leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[179] This rule applies regardless of whether the lessor or the

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

[176] For purposes of this provision, purchase is defined as under section 179(d).

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

[178] December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

[179] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various

lessee places the leasehold improvements in service.[180] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.[181]

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001, and before January 1, 2007 (and not subject to a binding contract on September 10, 2001), in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a nine-year recovery period. A taxpayer may elect out of the 5-year (and 9-year) recovery period for qualified NYLZ leasehold improvement property.

Increased section 179 expensing for qualified New York Liberty Zone property

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

For taxable years beginning in 2008 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by

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components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[180] Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

[181] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

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

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased by the lesser of (1) $35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property for purposes of the NYLZ provision means section 179 property[182] purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.[183]

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

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

Extended replacement period for New York Liberty Zone involuntary conversions

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the

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[182] As defined in sec. 179(d)(1).

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

disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[184] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[185]

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

Description of Proposal

Repeal of certain NYLZ incentives

The proposal repeals the four NYLZ incentives relating to the additional first-year depreciation allowance of 30 percent, the five-year depreciation of leasehold improvements, the additional section 179 expensing, and the extended replacement period for involuntary conversions.[186]

Effective date.–The proposal is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law. The extended replacement period for involuntarily converted property ends on the earlier of (1) the date of enactment or (2) the last day of the five-year period specified in the Jobs Creation and Worker Assistance Act of 2002 ("JCWAA"). [187]

Credit for certain payments of New York State and New York City

The proposal provides a Federal tax credit only for New York State and New York City, allowable against any payment by the State or City to the Federal government required under a provision of the Internal Revenue Code other than the provisions relating to payments of excise taxes, FICA, SECA, or OASDI amounts. For example, the credit is allowable against payments of Federal income tax withheld with respect to State or City employees.

The amount of the credit may not exceed the lesser of (1) $200 million per year (divided equally between the State and the City) for calendar years after 2005, until a cumulative total of

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[184] Section 1033(a)(2)(B).

[185] Section 1033(g)(4).

[186] The proposal does not change the present-law rules relating to certain NYLZ private activity bond financing and additional advance refunding bonds.

[187] Pub. Law No. 107-147, sec. 301 (2002).

$2 billion is reached, or (2) expenditures for the calendar year by the State or City, respectively, relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. Any amount of unused credit below the $200 million annual limit is carried forward to the following year, and expenditures that exceed the $200 million annual limit are carried forward and subtracted from the $200 million annual limit in the following year.

Treasury guidance is to be provided to ensure that the expenditures satisfy the intended purposes. The amount of the credit would be treated as State and local funds for purposes of any Federal program.

Effective date.–The proposal is effective for calendar years after 2005.

Analysis

The proposal is based on the premise that some of the tax benefits provided by the present-law incentive provisions will not be usable in the form in which they were originally provided, and that they should be replaced with other benefits which would have a greater impact on the recovery and continued development in the NYLZ. The proposal reflects a preference for subsidizing transportation infrastructure rather than buildings and other private property. Even to the extent that the incentive provisions can be used by taxpayers in their present-law form, they are arguably unnecessary to spur investment in the NYLZ because investment would occur in the area even without special tax incentives.

On the other hand, the effectiveness of the present-law NYLZ incentives may not yet be determinable because insufficient time has passed since they were enacted. Furthermore, repeal of the provisions prior to their scheduled expiration could be unfair to any taxpayers who have begun, in reliance upon the incentive provisions, to implement long-term plans the status of which requires them to continue with planned investments despite the absence of a written binding contract. Opponents may also object to the replacement of a benefit for private taxpayers with a cash grant to governmental entities, or the replacement of an incentive for investment in private property with an incentive for investment in public infrastructure.

The proposal could be criticized as creating an inefficient method for delivering a Federal transportation infrastructure subsidy to New York State and New York City. Further, because neither New York City nor New York State is subject to Federal income tax itself, administration of the Federal tax law is made needlessly complex by the creation of a credit against payment of withheld income tax of these governmental entities' employees. Providing a transportation infrastructure subsidy as a direct grant outside of the tax law would be more consistent with simplification of the tax law and administrative efficiency.

Prior Action

The NYLZ incentives were enacted as part of JCWAA. In 2003, the Senate amendment to H.R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003, would have permitted property purchased by another member of the taxpayer's affiliated group (in lieu of the taxpayer)

to be treated as replacement property for purposes of the provision.[188] The provision was not included in the conference agreement.[189]

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

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

III. SIMPLY THE TAX LAWS FOR FAMILIES

A. Repeal Phase-Out for Adoption Provisions

Present Law

Tax credit

A maximum nonrefundable credit of $10,630 per eligible child is allowed for qualified adoption expenses paid or incurred by the taxpayer for 2005. This amount is adjusted for inflation annually. An eligible child is an individual (1) who has not attained age 18 or (2) who is physically or mentally incapable of caring for him or herself.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption are qualified adoption expenses. Generally, a taxpayer is not eligible for the adoption credit in the year that qualified adoption expenses are paid or incurred by the taxpayer, but rather in the next taxable year. An exception is provided for qualified adoption expenses paid or incurred in the year the adoption becomes final.

In the case of a special needs child, the adoption expenses taken into account are increased by the excess, if any, of $10,630 over actual qualified adoption expenses otherwise taken into account for that special needs child. A special needs child is an eligible child who also meets other requirements. Specifically, a special needs child must be a citizen or resident of the United States which the State has determined: (1) cannot or should not be returned to the home of the birth parents, and (2) has a specific factor or condition because of which the child cannot be placed with adoptive parents without adoption assistance.

Exclusion from income

Present law provides a maximum $10,630 exclusion from the gross income of an employee for qualified adoption expenses (as defined above) paid by the employer. This amount is adjusted for inflation annually. The $10,630 limit is a per-child limit, not an annual limitation. In the case of a special needs adoption, the amount of adoption expenses taken into account in determining the exclusion for employer-provided adoption assistance is increased by the excess, if any, of $10,630 over the amount of the aggregate adoption expenses otherwise taken into account for that special needs child.

Phaseout of credit and exclusion

The otherwise allowable credit and exclusion for 2004 is phased out ratably for taxpayers with adjusted gross income (AGI) above $159,450, and is fully phased out at $199,450 of modified AGI. These amounts are adjusted for inflation annually. For purposes of the phaseout of the credit, AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

For purposes of the phaseout of the exclusion, AGI is determined without regard to the adoption exclusion and the deductions under sections 199, 221, 222 (relating to income attributable to domestic production, interest on educational loans, and qualified tuition and related expenses and is increased by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

Description of Proposal

The proposal repeals the income phase-outs of the adoption credit and the exclusion for qualified adoption expenses.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2005.

Analysis

Repeal of the phase-outs of the adoption credit and of the exclusion of adoption assistance simplifies the tax system for those claiming the credit or exclusion. Removing the phase-outs reduces the uncertainty as to whether a taxpayer is eligible for the credit or exclusion, and simplifies preparation of tax returns for those who adopt children. Additionally, for taxpayers beyond the phase-out range (no credit or exclusion allowed) or in the phase-out range (credit or exclusion limited), the repeal of the phase-outs creates, or increases, a financial incentive to adopt children. Opponents of repeal may argue that it is appropriate to restrict the benefits of the credit or exclusion such that the highest income taxpayers, who can afford to adopt without additional assistance, do not receive a tax reduction as a result of adopting children.[190]

Prior Action

A similar proposal was included in the President's fiscal year 2004 and 2005 budget proposals.

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[190] For a complete discussion of policy issues with regard to the elimination of phase-outs, see Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, at 79-91 (JCS-3-01), April 2001. This study includes recommendations to repeal many phase-outs, including the phaseout relating to the adoption credit and exclusion.

B. Clarify Eligibility of Siblings and Other Family Members for Child-Related Tax Benefits

Present Law

Uniform definition of qualifying child

In general

Present law provides a uniform definition of qualifying child (the "uniform definition") for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. A taxpayer generally may claim an individual who does not meet the uniform definition (with respect to any taxpayer) as a dependent if the dependency requirements are satisfied. The uniform definition generally does not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children of the taxpayer qualify for each tax benefit.

Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

The support and gross income tests for determining whether an individual is a dependent generally do not apply to a child who meets the requirements of the uniform definition.

Residency test

Under the uniform definition's residency test, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. As was the case under prior law, temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, are not treated as absences.

Relationship test

In order to be a qualifying child, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. For purposes of determining whether an adopted child is treated as a child by blood, an adopted child means an individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.

Age test

The age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child.

In general, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. A child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit, and under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

A child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. However, a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income credit.

Tie-breaking rules

If a child would be a qualifying child with respect to more than one individual (e.g., a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time, and second with respect to the parent with the highest adjusted gross income. Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

Interaction with other rules

Taxpayers generally may claim an individual who does not meet the uniform definition with respect to any taxpayer as a dependent if the dependency requirements (including the gross income and support tests) are satisfied.[191] Thus, for example, a taxpayer may claim a parent as a dependent if the taxpayer provides more than one half of the support of the parent and the parent's gross income is less than the personal exemption amount. As another example, a grandparent may claim a dependency exemption with respect to a grandson who does not reside with any taxpayer for over one half the year, if the grandparent provides more than one half of the support of the grandson and the grandson's gross income is less than the personal exemption amount.

Citizenship and residency

Children who are U.S. citizens living abroad or non-U.S. citizens living in Canada or Mexico may qualify as a qualifying child, as is the case under the dependency tests. A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a qualifying child (provided other applicable requirements are met) if (1) the child's

[191] Individuals who satisfy the present-law dependency tests and who are not qualifying children are referred to as "qualifying relatives".

principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States.

Children of divorced or legally separated parents

A custodial parent may release the claim to a dependency exemption (and, therefore, the child credit) to a noncustodial parent. Thus, custodial waivers that are in place and effective on the date of enactment will continue to be effective after the date of enactment if they continue to satisfy the waiver rule. In addition, the custodial waiver rule applies for purposes of the dependency exemption (and, therefore, the child credit) for decrees of divorce or separate maintenance or written separation agreements that become effective after the date of enactment. The custodial waiver rules do not affect eligibility with respect to children of divorced or legally separated parents for purposes of the earned income credit, the dependent care credit, and head of household filing status.

If a waiver is made, the waiver applies for purposes of determining whether a child meets the definition of a qualifying child or a qualifying relative under section 152(c) or 152(d) as amended by the provision. While the definition of qualifying child is generally uniform, for purposes of the earned income credit, head of household status, and the dependent care credit, the uniform definition is made without regard to the waiver provision.[192] Thus, a waiver that applies for the dependency exemption will also apply for the child credit, and the waiver will not apply for purposes of the other provisions.

Other provisions

A taxpayer identification number for a child be provided on the taxpayer's return. For purposes of the earned income credit, a qualifying child is required to have a social security number that is valid for employment in the United States (that is, the child must be a U.S. citizen, permanent resident, or have a certain type of temporary visa).

Earned income credit

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

An individual who is a qualifying child of another individual is not eligible to claim the earned income credit. Thus, in certain cases a taxpayer caring for a younger sibling in a home with no parents would be ineligible to claim the earned income credit based solely on the fact that the taxpayer is a qualifying child of the younger sibling if the taxpayer meets the age, relationship and residency tests.

[192] See secs. 2(b)(1)(A)(i) and 32(c)(3)(A) and sec. 21(e)(5).

Description of Proposal

Limit definition of qualifying child

The proposal adds a new requirement to the uniform definition. Specifically, it provides that an individual who otherwise satisfies the definition of a qualifying individual for purposes of the uniform definition is not treated a qualifying child unless he or she is either: (1) younger than the individual claiming him or her as a qualifying child or (2) permanently and totally disabled.

Restrict qualifying child tax benefits to child's parent

The proposal provides that if a parent resides with a qualifying child for more than half the taxable year then only the parent can claim the child as a qualifying child. However, the parent could allow another member of the household to claim the qualifying child if the other individual: (1) has a higher AGI for the taxable year; and (2) otherwise is eligible to claim the qualifying child.

Effective date

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

Analysis

In general

The proposed changes to the uniform definition are intended to restore eligibility for the earned income credit to certain lower-income siblings while eliminating a tax planning opportunity for more affluent families. As discussed below, each element of the proposal would achieve its intended result. However, the proposal would also constitute the third change in the earned income credit eligibility requirements since 2001. The earned income credit eligibility requirements were changed by Economic Growth and Tax Relief Reconciliation Act of 2001 and the Working Families Tax Relief Act of 2004. Beneficiaries of the earned income credit are more likely to be less sophisticated than other taxpayers. For this reason, changes to the uniform definition may adversely affect the ability of lower income individuals to understand their eligibility for child-related benefits such as the earned income credit. This is particularly important in an area that has a history of high taxpayer error rates.

Limit definition of qualifying child

The proposal is intended to restore eligibility for the earned income credit to certain individuals. It applies to certain working lower-income siblings with respect to their siblings where no other taxpayers reside in the household. Under present law, such siblings would be ineligible for the earned income credit to the extent they could each be the qualifying child of the other. For example, a 20-year-old woman who is a full-time student and the legal guardian of her 15-year-old brother would be unable to claim him as her qualifying child. It can be argued that denying the earned income credit in such a case was an unintended consequence of the enactment of a uniform definition. Further, the earned income credit arguably is intended to provide assistance in this kind of situation.

One situation that would not benefit from the proposal would be a circumstance where a younger sibling is supporting an older sibling. Such a situation may arise, for example, where a younger sibling is working but the older sibling is a full-time student. The proposal could have addressed this circumstance and restored eligibility for the earned income credit to this group by denying status as a qualifying child to siblings with lower incomes rather than to siblings that are younger.

Restrict qualifying child tax benefits to child's parent

Under certain fact patterns (e.g., certain multi-generational families), where more than one taxpayer within a family can claim a qualifying child for certain tax benefits, the members of the family may arrange to maximize their tax benefits. This planning opportunity was available in the case of the earned income credit before the enactment of the uniform definition in 2004. The enactment of the uniform definition potentially expanded this planning opportunity to other child-related tax benefits. For example, if a grandparent, parent, and child share the same household, under present law the grandparent and parent can decide which of them should claim the qualifying child in order to maximize tax benefits. If the parent earns $40,000 a year and the grandparent $20,000, it may be more advantageous for the grandparent to claim the qualifying child in order to receive the earned income credit, which the parent is ineligible for due to his level of earnings. Under the proposal, the grandparent could not claim the qualifying child because his adjusted gross income is less than that of the parent.

The uniform definition has another, arguably unintended consequence. In certain fact patterns, the uniform definition extends tax benefits to certain families who otherwise would not qualify (e.g. when the parents' income exceeds otherwise applicable income levels) or increases benefits to certain qualifying families. For example, it may be possible in certain circumstances and financially advantageous for the family as a whole, for parents to forgo claiming a child as a qualifying child so that an older child living at home may claim such child as a qualifying child. This would be most advantageous in circumstances in which the parents have income above the phaseout limits for the child credit or where the older sibling becomes eligible for the earned income credit by claiming the younger sibling as a qualifying child.

Under the circumstances described above, the uniform definition provides a tax planning opportunity for families that are more affluent and arguably less in need of a tax benefit. The proposal addresses these situations by limiting the ability of a non-parent to claim a child as a qualifying child when the child lives with his or her parents for over half the year.

Prior Action

No prior action.

IV. PROVISIONS RELATED TO THE EMPLOYER-BASED PENSION SYSTEM

A. Provisions Relating to Cash Balance Plans

Present Law

Overview

Types of qualified plans in general

Qualified retirement plans are broadly classified into two categories, defined benefit pension plans and defined contributions plans, based on the nature of the benefits provided. In some cases, the qualification requirements apply differently depending on whether a plan is a defined benefit pension plan or a defined contribution plan.

Under a defined benefit pension plan, benefits are determined under a plan formula, generally based on compensation and years of service. For example, a defined benefit pension plan might provide an annual retirement benefit of two 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.

Employer contributions to a defined benefit pension plan are subject to minimum funding requirements under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA") to ensure that plan assets are sufficient to pay the benefits under the plan. An employer is generally subject to an excise tax for a failure to make required contributions. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC").

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 (commonly called "401(k) plans" after the section of the Internal Revenue Code regulating such plans) are examples of defined contribution plans.

Cash balance plans

A "hybrid" plan is a plan that combines the features of a defined benefit pension plan and a defined contribution plan. In recent years, more employers have adopted cash balance plans (and other hybrid plans).

A cash balance plan is a defined benefit pension plan with benefits resembling the benefits associated with defined contribution plans. Under a cash balance plan, benefits are defined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits").

The method of determining interest credits under a cash balance plan is specified in the plan. Under one common plan design, interest credits are determined in the form of hypothetical interest on the account at a rate specified in the plan or based on a specified market index, such as the rate of interest on certain Treasury securities. Alternatively, interest credits are sometimes based on hypothetical assets held in the account, similar to earnings on an account under a defined contribution plan, which are based on the assets held in the account.[193]

Cash balance plans are generally designed so that, when a participant receives a pay credit for a year of service, the participant also receives the right to future interest on the pay credit, regardless of whether the participant continues employment (referred to as "front-loaded" interest credits). That is, the participant's hypothetical account continues to be credited with interest after the participant stops working for the employer. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account. Some early cash balance plans provided interest credits only while participants' remained employed (referred to as "back-loaded" interest credits). That is, a participant's hypothetical account was not credited with interest after the participant stopped working for the employer.

Overview of qualification issues with respect to cash balance plans

Cash balance plans are subject to the qualification requirements applicable to defined benefit pension plans generally. However, because such plans have features of both defined benefit pension plans and defined contributions plans, questions arise as to the proper application of the qualification requirements to such plans. Some issues arise if a defined benefit pension plan with a traditional defined benefit formula is converted to a cash balance plan formula, while others arise with respect to all cash balance plans.[194] Issues that commonly arise include: (1) in the case of a conversion to a cash balance plan formula, the application of the rule prohibiting a cutback in accrued benefits;[195] (2) the proper method for determining lump-sum distributions;[196] and (3) the application of the age discrimination rules.[197] These rules are discussed below.

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[193] The assets of the cash balance plan may or may not include the assets or investments on which interest credits are based. As in the case of other defined benefit pension plans, a plan fiduciary is responsible for making investment decisions with respect to cash balance plan assets.

[194] The conversion of a defined benefit pension plan to a cash balance plan generally means that the plan is amended to change the formula for accruing benefits from a traditional defined benefit formula to a cash balance formula. In such cases, the plan with the old formula and the plan as amended with the new formula are sometimes referred to as different plans, even though legally there is not a separate new plan.

[195] Sec. 411(d)(6); ERISA sec. 204(g).

[196] Sec. 417(e); ERISA sec. 205(g).

[197] Sec. 411(b)(1)(G) and (H); ERISA sec. 204(b)(1)(G) and (H); Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. 623(i).

Other issues have been raised in connection with cash balance plans, including the proper method for applying the accrual rules.[198]

There is little guidance under present law with respect to many of the issues raised by cash balance conversions. In 1999, the IRS imposed a moratorium on determination letters for cash balance conversions pending clarification of applicable legal requirements.[199] Under the moratorium, all determination letter requests regarding converted cash balance plans are sent to the National Office for review; however, the National Office is not currently acting on these plans.[200]

Benefit accrual requirements[201]

Several of the requirements that apply to qualified retirement plans relate to a participant's accrued benefit. For example, the vesting requirements apply with respect to a participant's accrued benefit. In addition, as discussed below, a plan amendment may not have the effect of reducing a participant's accrued benefit. In the case of a defined benefit pension plan, a participant's accrued benefit is generally the accrued benefit determined under the plan, expressed in the form of an annuity commencing at normal retirement age.[202]

The accrued benefit to which a participant is entitled under a defined benefit pension plan must be determined under a method (referred as the plan's accrual method) that satisfies one of three accrual rules. These rules relate to the pattern in which a participant's normal retirement benefit (i.e., the benefit payable at normal retirement age under the plan's benefit formula) accrues over the participant's years of service, so that benefit accruals are not "back-loaded" (i.e., delayed until years of service close to attainment of normal retirement age).

A participant's accrued benefit under a cash balance plan is determined by converting the participant's hypothetical account balance at normal retirement age to an actuarially equivalent annuity. Under a plan providing front-loaded interest credits, benefits attributable to future interest credits on a pay credit become part of the participant's accrued benefit when the participant receives the pay credit. Thus, for purposes of determining the accrued benefit, the participant's hypothetical account balance includes projected future pay credits for the period until normal retirement age. This has the effect of front-loading benefit accruals.

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[198] Sec. 411(b); ERISA sec. 204(b).

[199] Announcement 2003-1, 2003-2 I.R.B. 281.

[200] *Id.*

[201] Sec. 411(b); ERISA sec. 204(b).

[202] Sec. 411(a)(7). If a plan does not provide an accrued benefit in the form of an annuity commencing at normal retirement age, the accrued benefit is an annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit determined under the plan. Treas. Reg. sec. 1.411(a)-7(a)(1)(ii).

Under a plan providing back-loaded interest credits, benefits attributable to interest credits do not accrue until the interest credits are credited to the employee's account. Thus, as a participant's account balance grows over time, the amount of interest credited to the account increases, with a resulting increase in the participant's accrued benefit. The IRS has indicated that plans that provide back-loaded interest credit typically will not satisfy any of the accrual rules.[203]

Protection of accrued benefits; "wearaway" under cash balance plans

In general

The Code generally prohibits an employer from amending a plan's benefit formula to reduce benefits that have already accrued (the "anticutback rule").[204] For this purpose, an amendment is treated as reducing accrued benefits if it has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy or of eliminating an optional form of benefit.[205]

The anticutback rule applies in the context of cash balance plan conversions. Because of this rule, after conversion to a cash balance formula, a plan must provide employees at least with the normal retirement benefit that he or she had accrued before the conversion, as well as with any early retirement benefits or other optional forms of benefit provided before the conversion. However, the plan may determine benefits for years following the conversion in a variety of ways, while still satisfying the anticutback rule. Common plan designs are discussed below.

Wearaway (or "greater of" approach)

Upon a conversion to a cash balance plan, participants are generally given an opening account balance. The pay and interest credits provided under the plan are then added to this opening account balance. The opening account balance may be determined in a variety of ways and is generally a question of plan design. For example, an employer may create an opening account balance that is designed to approximate the benefit a participant would have had, based on the participant's compensation and years of service, if the cash balance formula had been in effect in prior years. As another example, an employer may convert the preconversion accrued benefit into a lump-sum amount and establish this amount as the opening account balance. Depending on the interest and mortality assumptions used, this lump-sum amount may or may not equal the actuarial present value of the participant's accrued benefit as of the date of conversion, determined using the statutory interest and mortality assumptions required in determining minimum lump-sum benefits (as discussed below).

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[203] Notice 96-8, 1996-1 C.B. 359.

[204] Sec. 411(d)(6); ERISA sec. 204(g). The provisions do not, however, protect benefits that have not yet accrued but would have in the future if the plan's benefit formula had not changed.

[205] Sec. 411(d)(6)(B); ERISA sec. 204(g)(2).

Under the wearaway approach, the participant's protected benefit (i.e., the preconversion accrued benefit) is compared to the normal retirement benefit that is provided by the account balance (plus pay and interest credits), and the participant does not earn any new benefits until the new benefit exceeds the protected accrued benefit. That is, the participant's benefit is the greater of the preconversion accrued benefit and the benefit provided by the cash balance account. Because of this effect, plans with a wearaway are also referred to as using the "greater of" method of calculating benefits. For example, suppose the value of the protected accrued benefit is $40,000, and the opening account balance under the cash balance formula provides a normal retirement benefit of $35,000. The participant will not earn any new benefits until the hypothetical balance under the cash balance formula increases to the extent that it provides a normal retirement benefit exceeding $40,000. Plan design can greatly affect the length of any wearaway period.[206]

No wearaway (or "sum of " approach)

Under a plan without a wearaway, a participant's benefit under the cash balance plan consists of the sum of (1) the benefit accrued before conversion plus (2) benefits under the cash balance formula for years of service after the conversion. This approach is more favorable to plan participants than the wearaway approach because they earn additional benefits under the new plan formula immediately. This approach is also sometimes referred to as the "A + B" method, where A is the protected benefit and B is the benefit under the cash balance formula.

Grandfathering

For older and longer-service participants, benefits under a cash balance formula may be lower than the benefits a participant may have expected to receive under the traditional defined benefit formula (the "old" formula).[207] The employer might therefore provide some type of "grandfather" to participants already in the plan or to older or longer-service employees. For example, the participants might be given a choice between the old formula and the cash balance formula for future benefit accruals, or, in the case or a final average pay plan, the plan may stop crediting service under the old formula, but continue to apply post-conversion pay increases, so the employee's preconversion benefit increases with post-conversion pay increases. This approach goes beyond merely preserving the benefit protected by the anticutback rule.

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[206] This description applies to normal retirement benefits. Other issues may arise with respect to early retirement benefits. For example, a plan might have provided a subsidized early retirement benefit before the conversion. After the conversion, the subsidized early retirement benefit must still be provided with respect to the preconversion accrued benefit. However, the plan is not required to provide a subsidized early retirement benefit with respect to benefits that accrue after the conversion.

[207] This is sometimes the reduction in benefits that is referred to in connection with cash balance conversions, i.e., a reduction in expected benefits, not accrued benefits.

Age discrimination

In general

The Code prohibits any reduction in the rate of a participant's benefit accrual (or the cessation of accruals) under a defined benefit pension plan because of the attainment of any age.[208] Parallel requirements exist in ERISA and the Age Discrimination in Employment Act ("ADEA").[209]

These provisions do not necessarily prohibit all benefit formulas under which a reduction in accruals is correlated with participants' age in some manner. Thus, for example, a plan may limit the total amount of benefits, or may limit the years of service or participation considered in determining benefits.[210]

In general terms, an age discrimination issue arises as a result of front-loaded interest credits under cash balance plans because there is a longer time for interest credits to accrue on hypothetical contributions to the account of a younger participant. For example, a $1,000 hypothetical contribution made when a plan participant is age 30 will be worth more at normal retirement age (e.g., age 65) and thus provide a higher annuity benefit at normal retirement age than the same contribution made on behalf of an older participant closer to normal retirement age. This age discrimination issue is not limited to cash balance plan conversions, but arises with respect to cash balance plans generally.[211]

Proposed Treasury regulations

In December 2002, the Treasury Department issued proposed regulations relating to the application of age discrimination prohibitions to defined benefit pension plans, including special rules for cash balance plans.[212] The proposed regulations provided guidance on how to

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[208] Sec. 411(b)(1)(H). Similarly, a defined contribution plan is prohibited from reducing the rate at which amounts are allocated to a participant's account (or ceasing allocations) because of the attainment of any age.

[209] ERISA sec. 204(b)(1)(H); ADEA, 29 U.S.C. Code sec. 623(i).

[210] Sec. 411(b)(1)(H)(ii); ERISA sec. 204(b)(1)(H)(ii).

[211] Other age discrimination issues may also arise in connection with cash balance plan conversions, depending in part on how the conversion is made, such as whether the plan has a "wearaway." However, the recent focus of age discrimination has related to the basic cash balance plan design.

[212] 67 Fed. Reg. 76123 (December 11, 2002). Prop. Treas. Reg. sec. 1.411(b)-2. The proposed regulations were issued after consideration of comments on regulations proposed in 1988. 53 Fed. Reg. 11876 (April 11, 1988).

determine the rate of benefit accrual under a defined benefit pension plan or rate of allocation under a defined contribution plan.[213]

Under the proposed regulations, subject to certain requirements, a cash balance formula that provides all participants with the same rate of pay credit and front-loaded interest credits generally does not violate the prohibition on age discrimination. In the case of a plan that is converted to a cash balance plan, the conversion generally must be accomplished in one of two ways in order to use the special rule. That is, in general, the converted plan must either: (1) determine each participant's benefit as not less than the sum of the participant's benefits accrued under the traditional defined benefit pension plan formula and the cash balance formula; or (2) establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's prior accrued benefit, using reasonable actuarial assumptions. The proposed regulations also allow a converted plan to continue to apply the traditional defined benefit formula to some participants.

Section 205 of the Consolidated Appropriations Act, 2004 (the "2004 Appropriations Act"),[214] enacted January 24, 2004, provides that none of the funds made available in the 2004 Appropriations Act may be used by the Secretary of the Treasury, or his designee, to issue any rule or regulation implementing the proposed Treasury regulations or any regulation reaching similar results. The 2004 Appropriations Act also required the Secretary of the Treasury within 180 days of enactment to present to Congress a legislative proposal for providing transition relief for older and longer-service participants affected by conversions of their employers' traditional pension plans to cash balance plans.[215]

On June 15, 2004, the Treasury Department and the IRS announced the withdrawal of the proposed age discrimination regulations including the special rules on cash balance plans and cash balance conversions.[216] According to the Announcement, "[t]his will provide Congress an opportunity to review and consider the Administration's legislative proposal and to address cash balance and other hybrid plan issues through legislation."[217] Treasury and the IRS that announced they do not intend to issue guidance on compliance with the age discrimination rules

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[213] The proposed regulations also addressed a number of other issues, including nondiscrimination testing for cash balance plans under section 401(a)(4). In April 2003, the Treasury Department announced it would withdraw the portion of proposed regulations relating to nondiscrimination testing because the regulations might make it difficult for employers to provide transition relief to participants upon conversions. Announcement 2003-22, 2002-17 I.R.B. 846 (April 28, 2003).

[214] Pub. L. No. 108-199 (2004).

[215] The Treasury Department complied with this requirement by including its cash balance proposal in the President's fiscal year 2005 budget proposal.

[216] Announcement 2004-57, 2004-27 I.R.B. 15 (June 15, 2004).

[217] *Id*.

for cash balance plans, cash balance conversions, or other hybrid plans or hybrid plan conversions while the issues are under consideration by Congress. As previously discussed, Treasury and the IRS also announced that they do not intend to process the technical advice cases pending with the National Office while cash balance issues are under consideration by Congress.

Case law

In response to employers' decisions to implement or convert to cash balance plans, several class action lawsuits have been brought by employees claiming that age discrimination requirements have been violated. Three Federal district court cases have addressed whether cash balance plans violate the age discrimination rules.[218]

In *Eaton v. Onan*,[219] a case of first impression, the court held that a cash balance plan did not violate the prohibition on reducing the rate of benefit accrual because of age.[220] Under the plan, participants received pay credits for each year of service as well as front-loaded interest credits. The court examined how the rate of an employee's benefit accrual was determined and found that the statute does not require that the rate of benefit accrual be measured solely in terms

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[218] Other decisions discussing the age discrimination issue do not directly address the issue, but are based on procedural errors or only discuss the issue as dicta. In *Campbell v. BankBoston, N.A.*, 206 F. Supp. 2d 70 (D. Mass. 2002), *aff'd*, 327 F.3d 1 (1st Cir. 2003), a district held that when the participant was credited with what he had accrued under the plan up to the date of conversion to a cash balance plan, the conversion did not show any intentional age discrimination. At the appeals court, the participant raised an additional claim that cash balance plan was age discriminatory under ERISA. Because the argument was not timely raised before the district court, it was waived. However, because the appeals court considered this a serious claim, it discussed the issue, principally citing the *Eaton v. Onan* decision. While the *BankBoston* decision is often cited for the position that cash balance plans are not age discriminatory, the appeals court did not actually resolve the ERISA age discrimination issue. In *Godinez v. CBS Corp*., 2003 U.S. App. LEXIS 23923 (9th Cir. Nov. 21, 2003), the appeals court upheld the district court's determination that the plaintiffs failed to make a prima facie case of discrimination since they could not show any disproportionate impact on older employees or offer statistical evidence demonstrating an age correlation (the older workers earned a larger pension benefit than similarly situated younger workers). In *Engers v. AT&T*, 2000 U.S. Dist. LEXIS 10937 (D.N.J. June 29, 2000), in dismissing a claim of deliberate discrimination under the ADEA relating to the treatment of participants, the district court held that the plaintiff's claim that AT&T's cash balance plan violated ERISA and the ADEA's age discrimination requirements could proceed to trial.

[219] 117 F. Supp. 2d 812 (S.D. Ind. 2000).

[220] The plaintiffs also raised an issue regarding whether the lump-sum payments violating age discrimination requirements. The court held that the defendants were entitled to summary judgment on that issue.

of change in the value of an annuity payable at normal retirement age. The court found that requiring the rate of benefit accrual to be measured in such way would produce a result inconsistent with the goal of the pension age discrimination provisions. The court found that in the case of a cash balance plan, the rate of benefit accrual should be defined as the change in the employee's cash balance account from one year to the next, thus determining that the cash balance plan was not age discriminatory.

After the proposed Treasury regulations were issued, a Federal district court in *Cooper v. IBM Personal Pension Plan*[221] held that cash balance formulas are inherently age discriminatory because identical interest credits necessarily buy a smaller age annuity at normal retirement age for older workers than for younger workers due to the time value of money. The court interpreted "rate of benefit accrual" as referring to an employee's age 65 annual benefit (i.e., annuity payable at normal retirement age) and the rate at which the age 65 annual benefit accrues. The court held that the interest credits must be valued as an age 65 annuity, so that interest credits would always be more valuable to a younger employee as opposed to an older employee, thus violating the prohibition on reducing the rate of benefit accrual because of age.

More recently, the U.S. District Court for the District of Maryland followed *Eaton v. Onan* and rejected the argument that cash balance plans are age discriminatory in *Tootle v. ARISC Inc.*[222] The court held that in examining the age discrimination issue, benefit accrual should be should be measured by examining the rate at which amounts are allocated and the changes in a participant's account balance over time.[223] According to the court, accrued benefit should be calculated under ERISA's provisions for defined contribution plans, rather than in terms of an age-65 annuity, as required for defined benefit plans.

Calculating minimum lump-sum distributions

Defined benefit pension plans are required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age.[224] If the plan permits benefits to be paid in certain other forms, such as a lump-sum distribution, the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age, determined using certain statutorily prescribed interest and mortality assumptions.

Although a participant's benefit under a cash balance plan is described in terms of a hypothetical account balance, like other defined benefit pension plans, a cash balance plan is

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[221] 274 F. Supp. 2d 1010 (S.D. Ill. 2003).

[222] *Tootle v. ARINC, Inc., et. al*., 2004 U.S. Dist. LEXIS 10629 (June 10, 2004).

[223] In *Tootle*, transition credits were provided on terms more favorable to older workers when the plan was converted to a cash balance plans, and the participant received a higher benefit under the cash balance plan than he would have received under the traditional defined benefit pension plan.

[224] Sec. 401(a)(11); ERISA sec. 205.

required to provide benefits in the form of an annuity payable at normal retirement age. Most cash balance plans are designed to permit lump-sum distributions of the participant's hypothetical account balance upon termination of employment. As is the case with defined benefit pension plans generally, such a lump-sum amount is required to be the actuarial equivalent to the annuity payable at normal retirement age, determined using the statutory interest and mortality assumptions.

IRS Notice 96-8 provides that determination of an employee's minimum lump sum under a cash balance plan that provides for front-loaded interest credits is calculated by: (1) projecting the participant's hypothetical account balance to normal retirement age by crediting future interest credits, the right to which has already accrued; (2) converting the projected account balance to an actuarially equivalent life annuity payable at normal retirement age, using the interest and mortality assumptions specified in the plan; and (3) determining the present value of the annuity (i.e., the lump-sum value) using the statutory interest and mortality assumptions.[225]

A difference in the rate of interest credits provided under the plan, which is used to project the account balance forward to normal retirement age, and the statutory rate used to determine the lump-sum value (i.e., present value) of the accrued benefit will cause a discrepancy between the value of the minimum lump-sum and the employee's hypothetical account balance. In particular, if the plan's interest crediting rate is higher than the statutory interest rate, then the resulting lump-sum amount will be greater than the hypothetical account balance. This result is sometimes referred to as "whipsaw." Several Federal appellate courts have addressed the calculation of lump-sum distributions under cash balance plans and have all followed the approach as described in IRS Notice 96-8.[226]

Description of Proposal

In general

The proposal provides rules for conversions of defined benefit pension plans to cash balance plans, applying the age discrimination requirements to cash balance plans, and

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[225] Secs. III.B. and C of Notice 96-8.

[226] *Berger v. Xerox Corp. Retirement Income Guarantee Plan,* 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), *cert. dismissed*, 531 U.S. 1061 (2001); *Lyons v. Georgia Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000), *cert. denied*, 532 U.S. 967 (2001); and *West v. AK Steel Corp. Retirement Accumulation Plan,* 2004 U.S. Dist. LEXIS 9224 (S.D. Ohio April 8, 2004). Additionally, under *Esden*, if participants accrue interest credits under a cash balance plan at an interest rate that is higher than the interest assumptions prescribed by the Code for determining the present value of the annuity, the interest credits must be reflected in the projection of the participant's hypothetical account balance to normal retirement age in order to avoid violating the Code's prohibition against forfeitures.

determining minimum lump-sum distributions from cash balance plans. The proposal makes conforming amendments to applicable rules under ERISA and ADEA.

Conversions to cash balance plans; wearaway

Under the proposal, for the first five years following the conversion of a traditional defined benefit pension plan to a cash balance plan, the benefits earned by any participant in the cash balance plan who was a participant in the traditional plan must be at least as valuable as the benefits the participant would have earned under the traditional plan had the conversion not occurred. Additionally, wearaway of normal and early retirement benefits in connection with a conversion to a cash balance plan is prohibited.

Failure to follow these requirements will not result in disqualification of the plan. However, a 100-percent excise payable by the plan sponsor will be imposed on any difference between required benefits and the benefits actually provided under a plan which has been converted to a cash balance formula. The amount of the excise tax cannot exceed the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income, whichever is greater. The excise tax does not apply if participants are given a choice between the traditional defined benefit pension plan formula and the cash balance formula or if current participants are "grandfathered," i.e., permitted to continue to earn benefits under the traditional formula rather than the cash balance formula.

Age discrimination

Under the proposal, a cash balance plan satisfies age discrimination requirements if it provides pay credits for older participants that are not less than the pay credits for younger participants (in the same manner as under a defined contribution plan). Additionally, certain transition approaches used in conversions, such as preserving the value of early retirement subsidies, do not violate the age discrimination or other qualification rules. The proposal provides similar rules for other types of hybrid plans and for conversions from traditional defined benefit pension plans to other types of hybrid plans.

Calculating lump-sum distributions

The proposal permits the value of a lump-sum distribution to be determined as the amount of a participant's hypothetical account balance under a cash balance plan as long as the plan does not provide interest credits in excess of a market rate of return.[227] The Secretary of the Treasury is authorized to provide safe harbors for market rates of return and to prescribe appropriate conditions regarding the calculation of plan distributions.

[227] A proposal to change the interest rate used to determine minimum lump-sum values is discussed in Part IV.C.

Effective date

The proposal is effective prospectively. No inference is intended as to the status of cash balance plans or cash balance conversions under present law.

Analysis

In general

Issues relating to cash balance plans raise broader issues relating to the defined benefit pension plan system and retirement income security, as discussed below. The proposal addresses certain issues relating to cash balance plans, with three stated objectives: (1) to ensure fairness for older workers in cash balance conversions, (2) to protect the defined benefit pension plan system by clarifying the status of cash balance plans, and (3) removing the effective ceiling on interest credits in cash balance plans due to the way lump-sum benefits are calculated. Specific issues arise with respect to each part of the proposal. In addition, because the proposal is effective only prospectively, there will be continued uncertainty as to the legal status of cash balance plans created or converted before the date of enactment.

Retirement income security and cash balance plans

Helping to ensure that individuals have retirement income security is the major objective of the U.S. private pension system. The system is a voluntary system, relying heavily on tax incentives in order to encourage employers to establish qualified retirement plans for their employees. Although qualified plans are subject to a variety of legal requirements, employers generally may choose whether or not to adopt a qualified plan, the type of plan to adopt, the level of benefits to be provided, and many other plan features.

Over time, there has been a decline in defined benefit pension plan coverage compared to coverage under defined contribution plans. This has caused some to be concerned about a possible decline in retirement income security, and has focused attention on both defined contribution plans and defined benefit pension plans. Issues of retirement income security with respect to both types of plans have been the subject of recent Congressional hearings.

Traditional defined benefit pension plans are viewed by many as providing greater retirement income security than defined contribution plans. This is primarily because such plans provide a specific promised benefit. Employers bear the risk of investment loss; if plan contributions plus earnings are insufficient to provide promised benefits, the employer is responsible for making up the difference. Within certain limits, most defined benefit pension plan benefits are guaranteed by the PBGC. Investments of defined benefit pension plan assets are subject to ERISA's fiduciary rules and limitations on the amount of plan assets that may be invested in stock of the employer. In addition, defined benefit pension plans are subject to certain spousal benefit requirements that do not apply to most defined contribution plans. That is, defined benefit plans are required to provide benefits in the form of a joint and survivor annuity, unless the participant and spouse consent to another form of benefit.

In contrast, defined contribution plans do not promise a specific benefit, but instead pay the value of the participant's account. The plan participant bears the risk of investment loss.

Benefits provided by defined contribution plans are not guaranteed by the PBGC. The extent to which ERISA's fiduciary rules apply to a defined contribution plan depends on the particular plan structure; in many cases defined contribution plans allow plan participants to direct the investment of their accounts, in which case more limited fiduciary protections apply than in the case of defined benefit pension plans. ERISA's limitations on the amount of plan assets that may be invested in employer stock generally do not apply to defined contribution plans. In addition, under most defined contribution plans, the spouse has only the right to be named the beneficiary of the amount (if any) remaining upon the death of the employee.

Cash balance plans have become an increasing prevalent plan design and, as well, an increasing element in discussions regarding retirement income security and the future of the defined benefit plan system.

During the 1990s, conversions of traditional defined benefit pension plans to cash balance formulas were common among mid- to large-size employers. There was considerable media attention regarding such conversions, particularly in cases in which the plan contained a "wearaway" or in which older or longer-service employees close to retirement were denied the opportunity to continue to accrue benefits under the old plan formula. While perhaps complying with the law, such plan designs were viewed by many as unfair to certain participants. There was concern that some employers were adversely affecting participants in order to reduce costs. There was also concern that participants might not understand the effect of the conversion on their benefits (including future benefits the participant may have accrued under the old formula).[228]

Since then, cash balance plans have continued to be popular. While certain legal issues have remained, employers have continued to adopt cash balance plans. In many cases, employers have structured conversions to avoid or minimize potential adverse effects on older and longer-service employees.

Attention again focused on cash balance plans following the decision in *IBM*, which held that cash balance formulas violate the age discrimination rules. This case applies not only to conversions, but to all cash balance plans. This decision has called into question whether cash balance plans are a permitted form of pension benefit. The decision has resulted in uncertainty for those employers that currently offer cash balance plans and employees who are participants in such plans. It has also focused attention on the future of defined benefit pension plans and the role that cash balance play within the overall pension system.

Many view preserving cash balance plans as a means of preserving the defined benefit pension plan system, and as an important step in helping to ensure retirement income security.

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[228] These concerns led to the enactment of the present-law notice requirements regarding future reductions in benefit accruals. Sec. 4980F and ERISA sec. 204(h).

Many who hold this view argue that cash balance plans are more beneficial to many employees than a traditional defined benefit pension plan and should be a permitted plan design option.[229]

Unlike traditional defined benefit pension plans, which tend to benefit long-service participants who remain with a company until retirement, cash balance plans often benefit shorter service, more mobile workers. Cash balance plans also provide a more portable benefit than the traditional defined benefit pension plan. Thus, cash balance plans may be popular in industries or markets in which workers are relatively mobile or among groups of workers who go in and out of the workforce. Some participants also find cash balance plans easier to understand than a traditional defined benefit pension plan because their benefit is described in terms of an account balance.

Cash balance plans may be attractive to employers for various reasons. The adoption of a cash balance plan may enable employers to better manage pension liabilities. Some employers are concerned about the level of contributions that may be required to fund traditional defined benefit pension plans, especially because the required contributions may fluctuate over time. They argue that a cash balance plan design does not result in such unpredictable funding obligations.

On the other hand, some are concerned that cash balance plans are primarily adopted by employers who wish to cut costs and reduce future benefits. They argue that reductions in benefits are not as obvious with a conversion to a cash balance plan compared to plan changes within the traditional defined benefit pension plan structure. Even with the present-law requirements relating to notices of reductions in future benefit accruals, it is argued that plan participants do not understand how to compare cash balance benefits with traditional defined benefit pension plan benefits and that many employees mistakenly think that the cash balance formula, expressed as an account balance, provides comparable benefits when it does not. It is also argued that cash balance plans inherently discriminate against longer service older workers, and thus should not be encouraged as a plan design.

It is countered that if employers wish to reduce benefits, or eliminate benefits altogether, they could do so within the traditional defined benefit pension plan structure. Moreover, some argue, employers generally sponsor qualified retirement plans voluntarily. While tax incentives encourage employers to establish and maintain such plans, they are not required to do so. It is argued that the flexibility allowed by employers by cash balance plans enables employers to continue a defined benefit pension plan, as well as in many cases also provide a defined contribution plan, thus enhancing retirement income security.

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[229] Others argue that a more appropriate question is whether workers are better off under a cash balance plan or no defined benefit pension plan. They argue that defined benefit pension plan coverage is falling and that the traditional defined benefit pension plan continues to be a less and less viable and attractive option for many employers. Some view cash balance plans as a more likely design for the future and, if cash balance plans are not allowed to continue, defined benefit plan coverage will continue to decline, which will erode retirement income security.

Some also note that cash balance plans, while legally defined benefit pension plans, operate in a way that does not deliver the full protections of a traditional defined benefit pension plan. For example, many traditional defined benefit pension plans do not offer lump-sum distributions. In contrast, cash balance plans typically do. While some argue that this increases portability of benefits, others argue that cash balance plans discourage annuity benefits, which may erode retirement income security and may undermine spousal rights.

Some also comment that the risk of investment loss borne by employers, and the protections against such losses for employees, are fundamentally different in cash balance plans than in traditional defined benefit pension plans. In the case of a traditional defined benefit plan, the plan formula promises a specific benefit payable at normal retirement age. The employer bears the risk that plan assets will not be sufficient to provide the promised benefits and generally must make up investment losses. Rather than providing a specified benefit, a cash balance plan specifies interest credits. This design may reduce the employer's risk that plan assets will underperform compared to the interest credits provided under the plan, while giving the employer the benefit of greater than expected investment performance.

Some argue that, under certain cash balance plans designs, plan participants face investment risk similar to the risk under defined contribution plans. For example, this risk may exist to the extent that the hypothetical account balance in a cash balance plan is subject to investment losses and well as investment gains. While many cash balance plans are designed to protect against loss in value, others argue that it is permissible to tie interest credits to hypothetical investments that may incur losses. In that case, a decline in the value of a participant's hypothetical account balance may result in a decline in the participant's accrued benefit. Some argue that such declines are inconsistent with the basic concept of a defined benefit pension plan, i.e., a plan that provides a specified benefit to participants, in contrast to a defined contribution plan under which participants bear the risk of loss. They argue that cash balance plan designs under which participants bear the risk of investment loss (even if only on hypothetical investments) should not be permitted.

Some argue that to the extent proposals relating to cash balance plans are motivated by concerns about retirement income security that other proposals to address such concerns should also be considered. For example, some argue that addressing issues with respect to funding of traditional defined benefit pension plans would help make such plans more attractive to employers on an on-going basis. Some also argue that it may be appropriate to consider whether changes to the rules relating to defined contribution plans should be considered to enable such plans to provide greater retirement income security.

Conversions to cash balance plans; wearaway

The proposal is intended to ensure fairness for older workers in conversions of traditional defined benefit pension plans to cash balance plans. It provides rules relating to the benefits accrued by participants in defined benefit pension plans which are converted to cash balance plans. The proposal provides greater protection for longer-service participants than is currently required under the present-law rules prohibiting cut backs in accrued benefits.

By requiring that the benefits earned by a participant for the first five years following a conversion must be at least as valuable as the benefits the participant would have earned under the traditional plan had the conversion not occurred, participants in the plan who are close to retirement age are better protected against disadvantages of converting to a cash balance plan. Further, by prohibiting wearaway in a conversion to a cash balance plan with respect to the benefits of such participants, possible adverse effects on older and longer-service participants will be reduced.

On the other hand, some argue that the proposal does not go far enough in ensuring that older and longer service employees will not be disadvantaged. Some argue that all plan participants, or at least participants who have attained a certain age or number of years of service, should automatically be given the greater of benefits under the old plan formula or under the new plan formula. Others argue that any such additional requirement would cause employer qualified retirement plan costs to increase, and could cause employers to reduce benefits further or terminate existing plans. They argue that the proposal provides an appropriate balance between concerns about older workers and the need to provide flexibility to employers in order to maintain the voluntary pension system.

Some argue that the 100-percent excise tax on any difference between required benefits and the benefits actually provided under a plan which has been converted to a cash balance formula is sufficient to encourage compliance with the proposal. However, others argue that limiting the amount of the excise tax to the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income, whichever is greater, will allow plan sponsors to manipulate the timing of a conversion so that the requirements of the proposal can be avoided without imposition of the excise tax. They argue that absent the potential for plan disqualification, the efficacy of the proposal is diminished, or even eliminated.

Some argue that the proposal provides appropriate flexibility to employers and additional safeguards for employees, by allowing employers to avoid the excise tax by grandfathering participants under the old formula or giving employees a choice between the old and new formula. On the other hand, some point out that giving employees options increases complexity for plan participants, and that many participants may not adequately understand the differences between the new plan formula and the old plan formula. These concerns may be addressed, at least to some extent, by requiring that participants receive sufficient information to make an informed decision. As mentioned above, others would go further, and require that at least some employees be automatically given the greater of the two formulas. This would avoid the need for elections, and the possibility that an employee may unwittingly choose an option that is clearly worse than the old plan formula. On the other hand, some view such a requirement as unduly restricting employers options in plan design.

Age discrimination

By providing that cash balance plans satisfy the age discrimination rules if the plan provides pay credits for older participants that are not less than the pay credits for younger participants, the proposal provides certainty in this regard. Some have argued that if such certainty is not provided, employers will be disinclined to offer defined benefit pension plans, including cash balance plans, to their employees. By reducing uncertainty as to how cash

balance plans can meet age discrimination requirements, some would argue that employers will be more likely to sponsor (or continue to sponsor) defined benefit pension plans, including cash balance plans.

The age discrimination issue results from the effect of front-loaded interest credits, under which a participant receiving a pay credit also receives the right to future interest on the pay credit, regardless of whether the participant continues employment. Front-loaded interest credits cause benefits to accrue more quickly, which is generally viewed as advantageous to participants, especially participants who leave employment after a short period of service. However, some argue that front-loaded pay credits inherently favor younger participants and are thus age inherently discriminatory. They believe that for this, and other reasons, cash balance plans should not be permitted.

Calculating lump-sum distributions

The proposal is intended to eliminate situations in which the amount of a minimum lump-sum distribution required from a cash balance plan is greater than a participant's hypothetical account balance because the plan's interest crediting rate is higher than the statutory interest rate. The proposal departs from the analysis set out in IRS Notice 96-8 and followed by several Federal courts that have considered this issue.

Proponents argue that the cases are based on IRS rulings that pre-date the prevalence of cash balance plans and that apply rules that are inappropriate in a cash balance context. Further, they argue that, as a result of the present-law rules, employers have reduced the rate of interest credits under cash balance plans, thus reducing benefits for participants. The proposal avoids this result and thus, it is argued, will benefit plan participants by encouraging employers to use a higher rate of return than the statutorily-prescribed rate.

Others note that, for purposes of satisfying the accrual rules, benefits attributable to front-loaded interest credits are treated as part of the accrued benefit. They argue that, if benefits attributable to front-loaded interest credits are part of the accrued benefit, such benefits should be reflected in determining the minimum value of lump-sum distributions as required under present law. To the extent that a participant's hypothetical account balance is less than such minimum lump-sum value, a participant who receives a distribution of the hypothetical account balance has not received the full value of his or her accrued benefit. They argue that such a result is inconsistent with the protections provided by the vesting and accrual rules.

In order for the proposal to apply, the plan must not use interest credits in excess of a market rate of return, and the Secretary is to provide safe harbors as to what is a market rate. This aspect of the proposal raises issues as to how to determine a market rate of return. Recent discussions over what constitutes an appropriate replacement for the interest rate on 30-year Treasury obligations for purposes related to defined benefit pension plans reflects the degree of complexity which may be involved in prescribing such safe harbors. The effects of the proposal on plan benefits, and the ease with which the proposal can be implemented by employers, understood by employees, and administered by the IRS will depend in large part on the ability to determine measures of market rates of returns. Some argue that because so much depends on

what is a market rate of return under the proposal, it would be more appropriate to provide statutory guidance on this issue, rather than leave the issue for the Secretary to resolve.

Complexity

As a result of its study of Enron Corporation, performed at the direction of the Senate Committee on Finance, the staff of the Joint Committee on Taxation ("Joint Committee staff") found that the lack of guidance with respect to cash balance plan conversions and cash balance plans generally creates uncertainty for employers and employees. The Joint Committee staff recommended that clear rules for such plans should be adopted in the near future.[230]

The budget proposals help to reduce uncertainty with respect to cash balance plans by addressing certain issues that frequently arise with respect to cash balance plans. However, the proposals do not address all issues with respect to such plans. In addition, certain aspects of the proposals need further clarification, or may add some additional complexities. For example, additional clarification is needed with respect to types of transition approaches in conversions that do not violate age discrimination or other qualification rules, allowing participants to choose between a traditional defined benefit formula and cash balance formula in order to avoid the 100-percent excise tax, and the determination of a market rate of return for purposes of calculating lump-sum distributions.

Prior Action

An identical proposal was included in the President's fiscal year 2005 budget proposal.

[230] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, at 487.

B. Strengthen Funding for Single-Employer Pension Plans[231]

1. Background and summary

Helping to assure that individuals have retirement income security is the major objective of the U.S. private pension system. Federal law attempts to further this goal in various ways. The Code provides tax-favored treatment for employer-sponsored qualified retirement plans. ERISA applies many of the same requirements as the Code and provides employees with the means of pursuing their rights.

Defined benefit pension plans are considered by many to provide greater retirement income security than defined contribution plans. Factors that contribute to this view include the fact that such plans offer a specified benefit payable as an annuity for life, the employer bears the risk of investment loss, and benefits are guaranteed (within limits) by the PBGC in the event the plan terminates and plan assets are not sufficient to pay promised benefits. The minimum funding rules are designed to promote retirement income security by helping to assure that plan assets will be sufficient to pay promised benefits when due. If plans are not adequately funded by the employer, then the benefits promised under the plan may not be paid in full; In particular, if a plan terminates and the assets are not sufficient to pay benefits, participants may not receive the full value of the benefits due, even with the PBGC guarantee.

The minimum funding rules have been the focus of much attention in recent years. On one hand, attention has focused on the increase in required contributions under the deficit reduction contribution rules, caused in part by the combination of low interest rates that have increased the value of plan liabilities and market declines that have decreased the value of plan assets. Some view this combination as a temporary situation that has artificially increased the extent of pension plan underfunding. On the other hand, attention has focused also on large, severely underfunded plans maintained by insolvent employers that have terminated with resulting benefit losses to employees and increases in PBGC liabilities. Some therefore believe the present-law funding rules are inadequate. Many believe that resolution of funding issues is essential to the long-term viability of the defined benefit pension system.[232]

As of September 30, 2004, the PBGC reported a total deficit of $23.5 billion, more than double the 2003 fiscal year end deficit of $11.5 billion. The PBGC's deficit is the amount by which its liabilities exceed its assets.[233] The PBGC has noted that its financial state is a cause for

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[231] Additional information about the Administration's proposals relating to funding and the Pension Benefit Guaranty Corporation is available on the Department of Labor's website at www.dol.gov/ebsa/pensionreform.html.

[232] Many believe that resolution of the uncertainty surrounding cash balance plans is also essential to the long-term viability of the defined benefit pension system, as discussed more fully in connection with the Administration's proposal relating to cash balance plans in Part IV.A.

[233] A variety of estimates and assumptions are used by the PBGC in evaluating the present value of its liability for future benefits, including assumptions about future plan

concern. The Government Accountability Office ("GAO") has placed the PBGC on its high risk list. Although the PBGC is a Federal agency, it does not receive financing from general revenues. Instead, the PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate undefended plans, premiums paid with respect to plans covered by the PBGC insurance program, and investment earnings. Underfunding of defined benefit pension plans presents a risk to PBGC premium payors, who may have to pay for the unfunded liabilities of terminating plans, and plan participants, who may lose benefits if a plan terminates (even with the PBGC guarantee).

The President's budget contains a series of proposals designed to strengthen funding levels in defined benefit pension plans and ability of the PBGC to provide guaranteed benefits. These proposals consist of: (1) changes to the funding rules to measure a plan's funding status more accurately and to require faster funding of shortfalls, along with increased deduction limits to encourage additional contributions (as discussed above); (2) more accurate and timely reporting of funding status; (3) elimination of a grandfather rule that allows certain plans to exceed the limits on investments in employer securities and real property; (4) restrictions on benefit increases and accelerated distributions that result in increases in unfunded liabilities; (5) a prohibition on providing shutdown benefits; and (6) redesign of the PBGC premium structure, limits on the PBGC guarantee when an employer enters bankruptcy, and enabling the PBGC to perfect a lien for required contributions against the assets of an employer in bankruptcy.

2. Funding and deduction rules

Present Law

In general

Defined benefit pension plans are subject to minimum funding requirements.[234] The minimum funding requirements are designed to ensure that plan assets are sufficient to pay plan benefits when due. The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is

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terminations. According to the PBGC, this present value is particularly sensitive to changes in the underlying estimates and assumptions; changes in estimates and assumptions could materially change the present value of its liability for future benefits.

[234] Sec. 412; ERISA secs. 301-308. The minimum funding rules do not apply to governmental plans or to church plans, except church plans with respect to which an election has been made to have various requirements, including the funding requirements, apply to the plan. In some respects, the funding rules applicable to multiemployer plans differ from the rules applicable to single-employer plans. In addition, special rules apply to certain plans funded exclusively by the purchase of individual insurance contracts (referred to as "insurance contract" plans).

determined under one of a number of acceptable actuarial cost methods. Additional contributions are required under the deficit reduction contribution rules in the case of certain underfunded plans. No contribution is required under the minimum funding rules in excess of the full funding limit (described below).

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to a defined benefit pension plan to satisfy the minimum funding requirements for a plan year. In addition, contributions in excess of the amount needed to satisfy the minimum funding requirements may be deductible, subject to certain limits.

General minimum funding rules

Funding methods and general concepts

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan: (1) in level dollar amounts; (2) as a uniform percentage of payroll; (3) as a uniform amount per unit of service (e.g., $1 per hour); or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. For example, the cost attributable to a past service liability is generally amortized over 30 years.

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be

used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefit liabilities under the plan, as described below).

For funding purposes, the actuarial value of plan assets is generally used, rather than fair market value. The actuarial value of plan assets is the value determined under an actuarial valuation method that takes into account fair market value and meets certain other requirements. The use of an actuarial valuation method allows appreciation or depreciation in the market value of plan assets to be recognized gradually over several plan years.

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods: (1) each of which is reasonable individually; or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

Funding standard account

As an administrative aid in the application of the funding requirements, a defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan.[235] Other credits or charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments (discussed above) or (as discussed below) experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan's actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal

[235] Present law also provides for the use of an "alternative" funding standard account, which has rarely been used.

cost or future employee contributions. The gain or loss for a year from changes in actuarial assumptions is amortized as credits or charges to the funding standard account over ten years.

If minimum required contributions are waived (as discussed below), the waived amount is credited to the funding standard account. The waived amount is then amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded.

If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

If, as of the close of a plan year, the account reflects credits at least equal to charges, the plan is generally treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan. If credits to the funding standard account exceed charges, a "credit balance" results. The amount of the credit balance, increased with interest, can be used to reduce future required contributions. A credit balance may result, for example, if contributions in excess of minimum required contributions are made or if investment returns on plan assets are more favorable than assumed.

Additional contributions for underfunded plans

Under special funding rules (referred to as the "deficit reduction contribution" rules),[236] an additional contribution to a plan is generally required if the plan's funded current liability percentage is less than 90 percent.[237] A plan's "funded current liability percentage" is the actuarial value of plan assets as a percentage of the plan's current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined on a present-value basis.

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[236] The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

[237] Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

The amount of the additional contribution required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below), over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits. The amount of the additional contribution cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent. The amount of the additional contribution is applied as a charge to the funding standard account.

The deficit reduction contribution is the sum of (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.[238] The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. For example, if a plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit is not considered in determining additional contributions until the event has occurred. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

Required interest rate and mortality table

Specific interest rate and mortality assumptions must be used in determining a plan's current liability for purposes of the special funding rule. For plans years beginning before January 1, 2004, the interest rate used to determine a plan's current liability must be within a permissible range of the weighted average[239] of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. The permissible range is generally from 90 percent to 105 percent (120 percent for plan years beginning in 2002

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[238] If the Secretary of the Treasury prescribes a new mortality table to be used in determining current liability, as described below, the deficit reduction contribution may include an additional amount.

[239] The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period. Notice 88-73, 1988-2 C.B. 383.

or 2003).[240] The interest rate used under the plan generally must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.[241]

Under the Pension Funding Equity Act of 2004 ("PFEA 2004"),[242] a special interest rate applies in determining current liability for plan years beginning in 2004 or 2005.[243] For these years, the interest rate used must be within a permissible range of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. The permissible range for these years is from 90 percent to 100 percent. The interest rate is to be determined by the Secretary of the Treasury on the basis of two or more indices that are selected periodically by the Secretary and are in the top three quality levels available.

The Secretary of the Treasury is required to prescribe mortality tables and to periodically review (at least every five years) and update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.[244] The Secretary of the Treasury has required the use of the 1983 Group Annuity Mortality Table.[245]

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[240] If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

[241] Sec. 412(b)(5)(B)(iii)(II); ERISA sec. 302(b)(5)(B)(iii)(II). Under Notice 90-11, 1990-1 C.B. 319, the interest rates in the permissible range are deemed to be consistent with the assumptions reflecting the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.

[242] Pub. L. No. 108-218 (2004).

[243] In addition, under PFEA 2004, if certain requirements are met, reduced contributions under the deficit reduction contribution rules apply for plan years beginning after December 27, 2003, and before December 28, 2005, in the case of plans maintained by commercial passenger airlines, employers primarily engaged in the production or manufacture of a steel mill product or in the processing of iron ore pellets, or a certain labor organization.

[244] Sec. 412(l)(7)(C)(ii); ERISA sec. 302(d)(7)(C)(ii).

[245] Rev. Rul. 95-28, 1995-1 C.B. 74. The IRS and the Treasury Department have announced that they are undertaking a review of the applicable mortality table and have requested comments on related issues, such as how mortality trends should be reflected. Notice 2003-62, 2003-38 I.R.B. 576; Announcement 2000-7, 2000-1 C.B. 586.

Other rules

Full funding limitation

No contributions are required under the minimum funding rules in excess of the full funding limitation. In 2004 and thereafter, the full funding limitation is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets.[246] However, the full funding limitation may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limitation may be based on projected future benefits, including future salary increases.

Timing of plan contributions

In general, plan contributions required to satisfy the funding rules must be made within 8½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.[247] The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.

Funding waivers

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.[248] A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required

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[246] For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a percentage (170 percent for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the full funding limitation based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[247] Sec. 412(m); ERISA sec. 302(e).

[248] Sec. 412(d); ERISA sec. 303. Under similar rules, the amortization period applicable to losses may also be extended.

contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers may be granted within any period of 15 consecutive plan years.

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

Failure to make required contributions

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[249] The excise tax is 10 percent of the amount of the funding deficiency. In addition, a tax of 100 percent may be imposed if the funding deficiency is not corrected within a certain period.

If the total of the contributions the employer fails to make (plus interest) exceeds $1 million and the plan's funded current liability percentage is less than 100 percent, a lien arises in favor of the plan with respect to all property of the employer and the members of the employer's controlled group. The amount of the lien is the total amount of the missed contributions (plus interest).

Reversions of defined benefit pension plan assets

Defined benefit pension plan assets generally may not revert to an employer before termination of the plan and the satisfaction of all plan liabilities. In addition, the plan must provide for the reversion. A reversion prior to plan termination may result in disqualification of the plan and may constitute a prohibited transaction. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax.[250] The excise tax rate is generally 20 percent, but increases to 50 percent if the employer does make contributions to a replacement plan or make certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be fully vested.

If certain requirements are satisfied, a qualified transfer of excess assets of a defined benefit pension plan may be made to a separate account within the plan in order to fund retiree health benefits.[251] Excess assets generally means the excess, if any, of the value of the plan's assets[252] over the greater of (1) the accrued liability under the plan (including normal cost) or

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[249] Sec. 4971. An excise tax applies also if a quarterly installment is less than the amount required to cover the plan's liquidity shortfall.

[250] Sec. 4980.

[251] Sec. 420.

[252] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

(2) 125 percent of the plan's current liability. No transfer after December 31, 2013, is a qualified transfer.

Deductions for contributions

Employer contributions to qualified retirement plans are deductible, subject to certain limits. In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year.[253]

The maximum amount of deductible contributions is generally not less than the plan's unfunded current liability.[254] For purposes of determining the maximum amount of deductible contributions, an employer may elect to disregard the temporary interest rate change under PFEA 2004. In such a case, the interest rate used in determining current liability for deduction purposes must be within the permissible range (90 to 105 percent) of the weighted average of the interest rates on 30-year Treasury securities for the preceding four-year period.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.[255]

Description of Proposal

In general

In the case of single-employer plans, the proposal repeals the present-law funding rules and provides a new set of rules for determining minimum required contributions.[256] Under the proposal, the minimum required contribution to a defined benefit pension plan for a plan year is generally the sum of two amounts: (1) the payments[257] required to amortize over seven years the

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[253] Sec. 404(a)(1).

[254] Sec. 404(a)(1)(D). In the case of a plan that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program (sometimes referred to as "termination liability").

[255] Sec. 4972.

[256] The proposal does not change the funding rules applicable to multiemployer plans or insurance contract plans. Governmental plans and church plans continue to be exempt from the funding rules to the extent provided under present law.

[257] As discussed below, different payments may be required with respect to amortization bases established for different years.

amount by which the plan's funding target exceeds the market value of the plan assets; and (2) the plan's normal cost for the plan year.

The plan's funding target is generally the present value of benefits earned as of the beginning of the plan year. The plan's normal cost is generally the present value of benefits expected to be earned during the plan year. Under the proposal, present value is determined using interest rates drawn from a corporate bond yield curve and a mortality table prescribed by the Secretary of Treasury.[258] However, other assumptions used to determine the plan's funding target and normal cost depend on the financial status of the employer.

The proposal also changes the limit on deductible contributions.

Determination of funding target and normal cost

In general

In general, under the proposal, the funding target and normal cost for a plan are the plan's "ongoing liability" and "ongoing" normal cost. However, in the case of a plan maintained by a financially weak plan sponsor, the funding target and normal cost for the plan are the plan's "at-risk liability" and "at-risk" normal cost. Different actuarial assumptions apply in determining ongoing or at-risk liability and normal cost.

Ongoing liability and ongoing normal cost

A plan's ongoing liability for a plan year is the present value of future payments expected to be made from the plan to provide benefits earned as of the beginning of the plan year. Benefits taken into account for this purpose include early retirement benefits and similar benefits that participants will become entitled to as a result of future service, to the extent such benefits are attributable to benefits accrued as of the beginning of the plan year.

For purposes of determining a plan's ongoing liability, the present value of benefits is determined by discounting future expected payments under the plan using a corporate bond yield curve, as described below. Future expected benefit payments under the plan are determined using a mortality table prescribed by the Secretary of Treasury. The proposal generally does not require other specified assumptions to be used in determining ongoing liability. However, other assumptions, such as the rate of turnover among participants and early and normal retirement rates, must be actuarially reasonable based on experience for the plan (or other relevant historical experience if there is no experience for the plan). In addition, a reasonable assumption as to future benefits that will be paid in the form of a lump sum must be used.

Ongoing normal cost for a plan year is the present value of future payments expected to be made from the plan to provide benefits that accrue during the plan year. Benefits that accrue

[258] The Administration's fiscal year 2006 budget proposals also include a proposal to use interest rates drawn from a corporate bond yield curve in determining benefits subject to the minimum value rules, such as lump sums. This proposal is discussed in Part IV.C.

during the plan year include any benefit accruals that result from compensation increases during the plan year that are applied to previous years of service, such as under a plan that bases benefits on final average compensation. Ongoing normal cost is determined using the same actuarial assumptions used to determine ongoing liability.

At-risk liability and at-risk normal cost

A plan's at-risk liability for a plan year is also the present value of future payments expected to be made from the plan to provide benefits earned as of the beginning of the plan year, determined using a corporate bond yield curve and a mortality table prescribed by the Secretary of Treasury. However, certain specified additional assumptions must be used in determining at-risk liability. Specifically, at-risk liability must be determined by assuming that participants retire at the earliest retirement age permitted under the plan and that benefits are paid in the form of a lump sum (or in whatever form permitted under the plan results in the largest present value).[259] In addition, at-risk liability includes an additional amount, referred to as a loading factor.[260] The loading factor is $700 per plan participant plus four percent of the amount of the plan's at-risk liability, as determined without regard to the loading factor.

At-risk normal cost is the present value of future payments expected to be made from the plan to provide benefits that accrue during the plan year, determined using the same actuarial assumptions used to determine at-risk liability, including a loading factor of four percent of the amount of the plan's at-risk normal cost, as determined without regard to the loading factor.[261]

Financially weak status

Financially weak status applies if, as of the plan's valuation date, any plan sponsor has senior unsecured debt that is rated as not being investment grade by each nationally recognized rating organization that has issued a credit rating for the debt. Alternatively, if no plan sponsor has senior unsecured debt that is rated, financially weak status applies if all of the nationally recognized statistical rating organizations that have made an issuer credit rating for any plan sponsor have rated the sponsor as less than investment grade. However, financially weak status does not apply if any significant member of the plan sponsor's controlled group has senior unsecured debt that is rated as investment grade, regardless of whether that controlled group member is a plan sponsor of the plan.

Special rules apply in the case of plan sponsors that have neither unsecured debt that is rated nor an issuer credit rating. Such a plan sponsor is automatically treated as not being financially weak, provided that the total number of participants covered by defined benefit

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[259] These additional assumptions are intended to reflect behavior that may occur when the financial health of the plan sponsor deteriorates.

[260] The loading factor is intended to reflect the cost of purchasing group annuity contracts in the case of termination of the plan.

[261] At-risk normal cost does not include a loading factor of $700 per plan participant.

pension plans maintained by the sponsor is less than 500. If the total number of participants covered by defined benefit pension plans maintained by such a plan sponsor is 500 or more, whether the plan sponsor is financially weak is determined under regulations. It is expected that, under such regulations, financially weak status will be determined based on financial measures, such as whether the ratio of long-term debt to equity for the plan sponsor's controlled group is 1.5 or more. For this purpose, debt is expected to include the unfunded at-risk liability of any plans maintained by the plan sponsor, and equity is expected to be based on: (1) fair market value in the case of a privately held company; or (2) market capitalization in the case of a company, the stock of which is publicly traded.

If a plan sponsor becomes financially weak during a plan year, any resulting change in the plan's funding target (i.e., from ongoing liability to at-risk liability) and normal cost (i.e., from ongoing normal cost to at-risk normal cost) is phased in ratably over a five-year period beginning with the plan year following the year in which the plan sponsor becomes financially weak. This rule applies if a plan sponsor becomes financially weak either before or after enactment of the proposal, and the five-year phase-in period is determined without regard to whether any of the relevant years occurred before enactment of the proposal. If a plan sponsor's financial status changes during a plan year so that it is no longer financially weak, the plan's ongoing liability is the applicable funding target for the next plan year.

Interest rate based on corporate bond yield curve and transition rule

The funding target and normal cost applicable to a plan are determined using a series of interest rates drawn from a yield curve for high-quality zero-coupon corporate bonds ("corporate bond yield curve"). That is, the interest rates used to determine the present value of payments expected to be made under the plan reflect the interest rates for corporate bonds maturing at the times when the payments are expected to be made.[262] The corporate bond yield curve is to be issued monthly by the Secretary of Treasury, based on the interest rates (averaged over 90 business days) for high-quality corporate bonds (i.e., bonds rated AA) with varying maturities.

A special method of calculating a plan's funding target applies for plan years beginning in 2006 and 2007. For those years, the plan's funding target is the weighted average of: (1) the plan's funding target (i.e., ongoing or at-risk liability, as applicable) determined using a corporate bond yield curve; and (2) the plan's funding target determined using the "transition" interest rate. The transition interest rate is the interest rate that would apply if the statutory interest rate applicable in determining current liability for plan years beginning in 2005 continued to apply for plan years beginning in 2006 and 2007. That is, the interest rate used must be within a permissible range (from 90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds

[262] Typically, higher interest rates apply to bonds of longer durations, and lower interest rates apply to bonds of shorter durations. It is therefore expected that higher interest rates will generally apply in determining the present value of payments expected to be made further in the future, and lower interest rates will generally apply in determining the present value of payments expected to be made in the nearer future.

during the four-year period ending on the last day before the plan year begins. For plan years beginning in 2006, a weighting factor of 2/3 applies to the plan's funding target determined using the transition interest rate, and a weighting factor of 1/3 applies to the plan's funding target determined using a corporate bond yield curve. For plan years beginning in 2007, the respective weighting factors are 1/3 and 2/3.

A similar method applies in determining a plan's normal cost (i.e., ongoing or at-risk normal cost, as applicable) for plan years beginning in 2006 and 2007.

Valuation date

Under the proposal, a plan's funding target (i.e., ongoing or at-risk liability, as applicable), the plan's normal cost (i.e., ongoing or at-risk normal cost, as applicable), the market value of the plan's assets, and the minimum required contribution for a plan year are determined as of the valuation date for the plan year. If a plan has more than 100 participants, the plan's valuation date must be the first day of the plan year. If the plan has 100 or fewer participants, the plan's valuation date may be any day in the plan year.

If a plan's valuation date is after the first day of the plan year, benefits accruing between the first day of the plan year and the valuation date are disregarded in determining the plan's funding target for the plan year.[263] In addition, in determining the market value of plan assets as of the valuation date, any contribution made to the plan for the current plan year is disregarded and any contribution to be made to the plan for the prior year that has not yet been made is included in plan assets as a contribution receivable. For plan years beginning in 2007 or later, the present value of the contribution receivable is included in plan assets, and present value is determined using the average effective interest rate that applied in determining the plan's funding target for the prior plan year.

Minimum required contributions

Under the proposal, the minimum contribution required to be made to a plan for a plan year is generally the sum of: (1) the plan's normal cost for the plan year (i.e., ongoing or at-risk normal cost, as applicable); and (2) the payments required (as described below) to amortize the amount by which the plan's funding target for the plan year (i.e., ongoing or at-risk liability, as applicable) exceeds the market value of plan assets.[264]

Under the proposal, if the plan's funding target for the plan year beginning in 2006 exceeds the market value of the plan's assets for that year, an initial amortization base is established in the amount of the shortfall. Payments are then required in the amount needed to amortize the initial amortization base over seven years, starting with the plan year beginning in

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[263] Such benefits are taken into account in determining the plan's normal cost for the plan year.

[264] The present-law rules permitting the waiver of the minimum funding requirements continue to apply.

2006. The required amortization payments are determined on a level basis, using the applicable interest rates under the corporate bond yield curve.

For each subsequent plan year, the plan's funding target is compared with the sum of: (1) the market value of the plan's assets; and (2) the present value of any future required amortization payments (determined using the applicable interest rates under the corporate bond yield curve). If the plan's funding target exceeds that sum, an additional amortization base is established in the amount of the shortfall, and payments are required in the amount needed to amortize the additional amortization base over seven years. If, for a plan year, the sum of the market value of plan assets and the present value of any future required amortization payments exceeds the plan's funding target, no additional amortization base is established for that plan year.

All required amortization payments generally must be made over the applicable seven-year period.[265] However, if, for a plan year, the market value of the plan's assets is at least equal to the plan's funding target, any existing amortization bases are eliminated and no amortization payments are required.

If no amortization payments are required for a plan year, the minimum required contribution for the plan year is based solely on the plan's normal cost. Specifically, the minimum required contribution is the plan's normal cost, reduced by the amount (if any) by which the market value of the plan's assets exceeds the plan's funding target. Accordingly, no contribution is required for a plan year if the market value of the plan's assets is at least equal to the sum of the plan's funding target and the plan's normal cost for the plan year.

A contribution in excess of the minimum required contribution does not create a credit balance that can be used to offset minimum required contributions for later years. However, contributions in excess of the minimum (and income thereon) increase plan assets, which may have the effect of accelerating the elimination of amortization bases or of reducing contributions required with respect to normal cost.

Timing rules for contributions

As under present law, contributions required for a plan year generally must be made within 8-½ months after the end of the plan year. However, quarterly contributions are required to be made during a plan year if, for the preceding plan year, the plan's funding target exceeded the market value of the plan's assets, determined as of the valuation date for the preceding plan year.

A contribution made after the valuation date for a plan year is credited against the minimum required contribution for the plan year based on its present value as of the valuation date for the plan year. Present value is determined by discounting the contribution from the date

[265] Under the proposal, the present-law rules permitting the extension of amortization periods are repealed with respect to single-employer plans.

the contribution is actually made to the valuation date, using the average effective interest rate applicable in determining the plan's funding target for the plan year.

Maximum deductible contributions

Under the proposal, the limit on deductible contributions for a year is generally the amount by which the sum of the plan's funding target, the plan's normal cost, and the plan's cushion amount exceeds the market value of the plan's assets. The plan's cushion amount is the sum of: (1) 30 percent of the plan's funding target; and (2) the amount by which the plan's funding target and normal cost would increase if they were determined by taking into account expected future salary increases for participants (or, in the case of a plan under which previously accrued benefits are not based on compensation, expected future benefit increases, based on average increases for the previous six years). The increase in the plan's funding target and normal cost as a result of taking into account expected future salary or benefit increases is determined by applying the expected salary or benefit increase with respect to participants'service as of the valuation date for the plan year. For this purpose, the dollar limits on benefits and on compensation that apply for the plan year are used.

In addition, the limit on deductible contributions for a year is not less than the sum of: (1) the plan's at-risk normal cost for the year; and (2) the amount by which the plan's at-risk liability for the year exceeds the market value of the plan's assets. For this purpose, at-risk liability and at-risk normal cost are used regardless of the financial status of the plan sponsor.

Present-law rules permitting an employer to deduct a contribution made within the time for filing its tax return for a taxable year continue to apply.

Effective date

The proposal is effective for plan years beginning after December 31, 2005.

Analysis

General policy issues relating to the funding and deduction rules for defined benefit pension plans

The funding rules are a cornerstone of the defined benefit pension plan system and, over time, have been a frequent source of discussion and change. Proposals relating to the funding rules involve balancing competing policy interests.

The present-law minimum funding rules recognize that pension benefits are generally long-term liabilities that can be funded over a period of time. On the other hand, benefit liabilities are accelerated when a plan terminates before all benefits have been paid, as many plans do, and the deficit reduction contribution rules to some extent reflect the amount that would be needed to provide benefits if the plan terminated. Some argue that if minimum funding requirements are too stringent, funds may be unnecessarily diverted from the employer's other business needs and may cause financial problems for the business, thus jeopardizing the future of not just the employees' retirement benefits, but also their jobs. This suggestion tends to arise during a period of economic downturn, either generally or in a particular industry. Some also

argue that overly stringent funding requirements may discourage the establishment or continuation of defined benefit pension plans.

The limits on deductible contributions, the excise tax on nondeductible contributions, and the rules relating to reversions of defined benefit pension plan assets have as a major objective preventing the use of defined benefit pension plans as a tax-favored funding mechanism for the business needs of the employer. They also serve to limit the tax expenditure associated with defined benefit pension plans. Some argue that if the maximum limits on plan funding are too low, then benefit security will be jeopardized. They argue that employers need flexibility to make greater contributions when possible, in order to ensure adequate funding in years in which the business may not be as profitable. Others note that such flexibility is available as a result of the increases in the deduction limits under EGTRRA, but the full effect of the increases may not be apparent yet because of recent economic conditions. With respect to reversions, some argue that if restrictions on reversions are too strict, employers may be discouraged from making contributions in excess of the required minimums.

The desire to achieve the proper balance between these competing policy objectives has resulted in a variety of legislative changes to address the concerns arising at particular times. For example, the Omnibus Budget Reconciliation Act of 1987 made comprehensive changes to the minimum funding rules (including enactment of the deficit reduction contribution rules) prompted by concerns regarding the solvency of the defined benefit pension plan system. That Act also added the current liability full funding limit. Legislation enacted in 1990 allowed employers access to excess assets in defined benefit pension plans in order to pay retiree health liabilities. The Retirement Protection Act of 1994 again made comprehensive changes to the funding rules. Recent changes to the funding rules have focused on increasing the maximum deductible contribution, and on the interest rate that must be used to calculate required contributions. For example, EGTRRA increased the current liability full funding limit and then repealed the current liability full funding limit for 2004 and thereafter.

General analysis of the funding and deduction proposal

The proposed changes to the funding rules reflect the view that the present-law rules are ineffective in assuring that plans are adequately funded. For example, the valuation methods and amortization periods applicable under present law may have the effect of disguising a plan's true funding status. In some cases, these factors result in artificial credit balances that can be used to reduce required contributions. Thus, employers may fully comply with the present-law funding rules, yet still have plans that are substantially underfunded. In general, the proposal is intended to more accurately measure the unfunded liability of a plan and accelerate the rate at which contributions are made to fund that liability.

Under the proposal, a plan's funding status is measured by reference to the present value of plan liabilities, using a current interest rate, and the market value of plan assets. This approach is intended to provide a more accurate and up-to-date picture of the plan's financial condition. On the other hand, some point out that most plans are long-term arrangements and a measurement of assets and liabilities as of a particular date does not necessarily provide an accurate picture of the plan's status. Some are also concerned that elimination of the averaging and smoothing rules that apply under present law may result in increased volatility of required

contributions. They also note that the present-law averaging and smoothing rules allow employers to know in advance that higher plan contributions will be required, thereby providing some predictability in required contributions. They suggest that, by making required contributions more volatile and unpredictable, the proposal may discourage employers from continuing to maintain plans and thus may harm, rather than strengthen, the defined benefit pension plan system.

The proposal applies a more rigorous funding target in the case of a plan maintained by a financially weak employer. Under the proposal, financially weak status is generally based on a rating of the employer's debt as below investment grade by nationally recognized rating organizations. In some cases, financially weak status is determined in accordance with standards to be established under regulations. Some argue that credit ratings are simply not a reliable indicator of whether a plan will terminate on an underfunded basis. They note that many businesses with below investment grade ratings continue to operate and to maintain a defined benefit pension plan. Some also suggest that the possibility of greater required contributions could itself drive down an employer's credit rating. Some also express concern that, in some cases, Treasury and the IRS would be responsible for determining financial status.

If a plan terminates, in addition to the cost of benefits, costs are incurred to purchase annuity contracts to provide the benefits due under the plan. In addition, an economic decline in a business may cause employees to retire earlier and to take benefits in the form of a lump sum. The proposal requires these factors to be reflected in the determination of a plan's funding target in the case of a financially weak employer. This approach has the effect of increasing such liabilities and required contributions. Some view this approach as appropriate in order to reduce the financial risk posed by underfunded plans maintained by financially weak employers. Others argue that requiring such employers to make even greater required contributions may increase the risk that the plan will terminate on an underfunded basis.

Under the proposal, the changes to the deduction limits are intended to allow employers to make higher contributions when funds are available, thus improving the plan's funding status and reducing the contributions that may be required during a downturn in business. However, some argue that the elimination of the credit balance concept (which limits the ability to reduce future required contributions by additional contributions made in the past) undercuts the incentive to make additional contributions. In addition, some employers may have made additional contributions and generated credit balances as part of a planned funding strategy and elimination of existing credit balances may be viewed as disruptive. Some suggest that credit balances should be adjusted to reflect changes in plan asset values, but not eliminated. On the other hand, with respect to the proposed increase in the deduction limits, some note that, currently, most employers do not make contributions up to the present-law deduction limits. They suggest that raising the limits will primarily benefit employers who want to use the plan as a source of tax-free savings to provide funds for other purposes.

The present-law funding rules are complex, in part because they essentially consist of two sets of rules - the general rules that determine required contributions on an ongoing basis and the deficit reduction contribution rules that determine required contributions on a present-value basis. The proposal replaces these rules with a single set of rules, which reduces complexity. In addition, the methods used to determine minimum required contributions under the proposal are

less complex than the present-law rules involving the funding standard account and various amortization periods and valuation methods.

Background relating to interest rate used to measure pension liabilities

Recent attention has focused on the issue of the rate of interest used to determine the present value of benefits under defined benefit pension plans for purposes of the plan's current liability (and hence the amount of contributions required under the funding rules) and the minimum amount of lump-sum benefits under the plan.[266] For plan funding purposes, the use of a lower interest rate in determining current liability results in a higher present value of the benefits and larger contributions required to fund those benefits. Alternatively, the use of a higher interest rate results in a lower present value of future liabilities and therefore lower required contributions.

Under present law, the theoretical basis for the interest rate to be used to determine the present value of pension plan benefits for funding purposes is an interest rate that would be used in setting the price for private annuity contracts that provide similar benefits. Some studies have shown that it is not practicable to identify such a rate accurately because of variation in the manner in which prices of private annuity contracts are determined. As a result, the interest rate used to value pension benefits is intended to approximate the rate used in pricing annuity contracts.[267] Some have described this standard as a rate comparable to the rate earned on a conservatively invested portfolio of assets.

Under present law, the interest rate used to determine current liability (and minimum lump-sum benefits) has been based on the interest rate on 30-year Treasury obligations. The interest rate issue has received attention recently in part because the Treasury Department stopped issuing 30-year obligations. As a result, there is no longer a 30-year Treasury interest rate, and statutory changes are necessary to reflect this. In addition, some have argued that the 30-year Treasury rate has been too low compared to annuity rates, resulting in inappropriately high levels of minimum funding requirements on employers that are not necessary to maintain appropriate retirement income security.[268]

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[266] A proposal to use a corporate bond yield curve in determining minimum lump-sum benefits is discussed in Part IV.C.

[267] In practice, the price of an annuity contact encompasses not only an interest rate factor but also other factors, such as the costs of servicing the contract and recordkeeping. Under present law, the interest rate used for determining current liability is intended to embody all of these factors. See H.R. Rpt. No. 100-495, at 868 (1987).

[268] As discussed above, temporary increases in the permissible interest rate for purposes of determining current liability were enacted in 2002 and 2004.

Analysis of interest-rate proposal

Under the proposal, the rate of interest on 30-year Treasury securities is replaced with the rate of interest on high-quality corporate bonds for purposes of determining the present value of plan benefits for purposes of determining minimum required contributions. Initially, the interest rate used is based on a weighted average of the yields on high-quality long-term corporate bonds. After a transition period, the proposal provides for the use of a series of interest rates drawn from a yield curve of high-quality zero-coupon bonds with various maturities, selected to match the timing of benefit payments expected to be made from the plan.

Some believe that, compared with the rate of interest on 30-year Treasury securities, an interest rate based on long-term corporate bonds better approximates the rate that would be used in determining the cost of settling pension liabilities, i.e., by purchasing annuity contracts to provide the benefits due under the plan.[269] However, the proposal reflects the view that use of an interest rate based solely on long-term corporate bonds is inappropriate, and rather that multiple interest rates should be used to reflect the varying times when benefits become payable under a plan, because of, for example, different expected retirement dates of employees. The rationale for this approach is that interest rates differ depending, in part, on the term of an obligation. Because plan liabilities may be payable both in the short term and the long term, this approach would determine the present value of these liabilities with multiple interest rates, chosen to match the times at which the benefits are payable under the plan.

Some have raised concerns that a yield-curve approach is more complicated than the use of a single rate, particularly for smaller plans. Some have suggested that this could have the effect of increasing administrative costs associated with maintaining a defined benefit pension plan (and, in some cases, required contributions) and discourage the continuation and establishment of such plans. Some also question whether using a yield curve would result in such increased accuracy as to justify the complexity. Some have suggested that the use of a single rate, such as the long-term corporate bond rate, with an appropriate adjustment factor can produce results similar to the use of a yield curve, but much more simply.

Others have responded to these concerns by suggesting that, although a single interest rate is used to determine required contributions under the present-law funding rules, a yield-curve approach is commonly used for other purposes, such as corporate finance. Some also note that the determination of plan liabilities already involves the application of complicated actuarial concepts and the proposal does not add significant complexity. They argue moreover that any additional complexity is outweighed by the importance of measuring pension liabilities accurately, including the timing of benefit payments from the plan. In addition, it has been suggested that simplified methods (such as the use of a single composite rate) can be provided for smaller plans.

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[269] Some also argue that the interest rate used for funding purposes should be based on the expected return on plan investments, rather than on annuity purchase rates.

Some have questioned whether it is possible to construct a yield curve of corporate bond rates that is appropriate for measuring pension liabilities. They suggest that, for example, corporate bonds of certain durations that are available on the market are too limited to provide a reliable basis for constructing a yield curve. Some have also suggested that the proposal may be intended to encourage employers to invest plan assets more heavily in bonds, rather than in equities. Although, over time, returns on equity investments are expected to be higher than bond returns, equity investments are also subject to greater value changes, which can lead to volatility in plan asset values, which in turn may increase unfunded liabilities and minimum required contributions. Thus, investments in bonds may reduce volatility in the value of plan assets and in required contributions. Some argue that, to the extent plan assets are invested more heavily in bonds in order to reduce volatility in plan assets, the long term return on such plan might be lower than that achieved with an alternative portfolio invested less heavily in bonds, thus requiring greater employer contributions over time to meet plan liabilities. However, employers today face similar issues in the management of pension plans under the existing funding rules.

The proposal also eliminates the four year averaging period used to determine the interest rate applicable for purposes of determining current liability under present law. Some have suggested that such an averaging period is necessary to prevent rapid interest rate changes from causing corresponding changes in the value of pension liabilities, which in turn may result in volatility in the amount of minimum required contributions. The use of a yield curve, however, should to some extent mitigate volatility relative to the use of a single rate, as short and long term interest rates fluctuate to differing degrees and do not necessarily even move in the same direction. Others believe that the interest rate used to value pension liabilities should be designed to measure those liabilities as accurately as possible and that volatility in required contributions should be addressed through modifications to the funding and deduction rules. However, some argue that the proposal fails to address such volatility.

Prior Action

The President's fiscal year 2005 budget proposal included a proposal to use a yield curve of interest rates on corporate bonds in determining current liability for plan years beginning after December 31, 2007, with a phase-in for plan years beginning after December 31, 2005, and before January 1, 2008.

The National Employee Savings and Trust Equity Guarantee Act of 2004 ("NESTEG"), as reported by the Senate Committee on Finance on May 14, 2004, included a provision under which a yield curve of interest rates on corporate bonds is used in determining current liability for plan years beginning after December 31, 2010, with a phase-in for plan years beginning after December 31, 2006, and before January 1, 2011. NESTEG also contained a provision under which the limit on deductible contributions to a defined benefit pension plan is not less than the excess (if any) of: (1) 130 percent of the plan's current liability; over (2) the value of plan assets.

3. Form 5500, Schedule B actuarial statement and summary annual report

Present Law

Form 5500 and Schedule B actuarial statement

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation generally must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also may require the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC"). The plan administrator must use the Form 5500 series as the format for the required annual return.[270] The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Department of Labor, which forwards the form to the Internal Revenue Service and the PBGC.

Certain schedules must be filed with the Form 5500. Schedule B must be filed by most defined benefit pension plans (i.e., the requirement applies to all plans subject to the minimum funding standard) and includes actuarial information of the plan.[271] Information required in the actuarial report includes (1) a description of the funding method and actuarial assumptions used to determine costs under the plan; (2) a certification of the contribution necessary to reduce the accumulated funding deficiency to zero; (3) a statement that the report is complete and accurate and that the requirements relating to reasonable actuarial assumptions have been met; (4) other information as may be necessary to fully and fairly disclose the actuarial position of the plan; and (5) such other information as the Secretary may prescribe.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date may be extended up to two and one-half months.

Upon written request, a participant must be provided with a copy of the full annual report. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor. As discussed below, the plan administrator must automatically provide participants with a summary of the annual report. A plan administrator is also required to furnish participants with other notices and information about the plan.

Summary annual report

ERISA requires that plans furnish a summary annual report of the Form 5500 to plan participants and beneficiaries. The summary annual report must include a statement whether

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[270] Treas. Reg. sec. 301.6058-1(a).

[271] Code sec. 6059.

contributions were made to keep the plan funded in accordance with minimum funding requirements, or whether contributions were not made and the amount of the deficit. The current value of plan assets is also required to be disclosed. The summary annual report must be furnished within nine months after the close of the plan year. If an extension applies for the Form 5500, the summary annual report must be provided within two months after the extended due date. A plan administrator who fails to provide a summary annual report to a participant within 30 days of the participant making request for the report may be liable to the participant for a civil penalty of up to $100 a day from the date of the failure.

Participant notice of underfunding

Plan administrators of plans required to pay variable rate premiums to the PBGC are required to provide notice to plan participants and beneficiaries of the plan's funding status and the limits on the PBGC's guaranty should the plan terminate while underfunded.[272] The notice is generally due no later than two months after the filing deadline for the Form 5500 for the previous plan year and may be distributed with the plan's summary annual report.

Disclosure of certain plan actuarial and company financial information

Certain plan sponsors are required to annually provide the PBGC with records, documents, or other information that the PBGC specifies as necessary to determine the liabilities and assets of the plan.[273] The sponsor must also provide copies of audited financial statements, and such other information as the PBGC may prescribe. The disclosure is required on a controlled-group basis. Plan subject to this requirement include single-employer plans if (1) the aggregate unfunded vested benefits at the end of the preceding plan year of plans maintained by the contributing sponsor and members of its controlled group exceed $50,000,000; (2) the condition for imposing a lien for missed plan contribution exceeding $1 million have been met with respect to any member of the controlled group; or (3) minimum funding waivers in excess of $1 million have been granted with respect to any plan maintained by a member of the controlled group and any portion is still outstanding.

In general, the contents of annual reports, statement, and other documents filed with the Department of Labor under the reporting and disclosure provisions of ERISA are generally public information that must be made available for public inspection. Information or documentary materials submitted to the PBGC pursuant to ERISA section 4010 is exempt from disclosure under the Freedom of Information Act ("FOIA") and no such information or documentary materials may be made public, except as may be relevant to an administrative or judicial action or proceeding.

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[272] ERISA sec. 4011.

[273] ERISA sec. 4010.

Description of Proposal

Form 5500, Schedule B actuarial statement

Under the proposal, a plan's ongoing liability, at-risk liability (regardless of whether the employer is financially weak),[274] and the market value of the plan assets are required to be reported in the actuarial report (i.e., the Schedule B) filed with the plan's annual report. The proposal applies to all PBGC-covered, single-employer defined benefit pension plans.

In addition, if quarterly contributions are required with respect to a plan covering more than 100 participants (i.e., a plan that has assets less than the funding target as of the prior valuation date), the deadline for the actuarial report is accelerated. The actuarial report is due on the 15th day of the second month following the close of the plan year (February 15 for calendar year plans). If any contribution is subsequently made for the plan year, the additional contribution is required to be reflected in an amended Schedule B to be filed with the Form 5500.

Summary annual report

Under the proposal, the summary annual report provided to participants is required to include information on the funding status of the plan for each of the last three years. The funding status is required to be shown as a percentage based on the ratio of the plan's assets to its funding target. Information on the employer's financial status and on the PBGC benefit guarantee must also be provided. The proposal replaces the requirement of notice to participants of underfunding[275] with the summary annual report disclosure.

The summary annual report must be provided to participants no later than 15 days after the due date for filing the plan's annual report. A plan administrator that fails to provide a summary annual report on a timely basis is subject to a penalty.

Public disclosure of certain PBGC filings

The proposal eliminates the nondisclosure rules of section 4010(c) of ERISA, which exempt certain information filed with the PBGC from disclosure under FOIA. Under the proposal, information and documentation filed with the PBGC pursuant to ERISA section 4010

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[274] As previously discussed, for a plan sponsor that is not financially weak, the funding target is the plan's ongoing liability. For a plan sponsor that is financially weak, the funding target generally is the plan's at-risk liability. Ongoing liability and at-risk liability are previously discussed in detail. In general, a plan's ongoing liability for a plan year is the present value of future payments expected to be made from the plan to provide benefits earned as of the beginning of the plan year. At-risk liability is based on the same benefits and assumptions as ongoing liability, except that the valuation of those benefits would require the use of certain actuarial assumptions to reflect the concept that a plan maintained by a financially weak plan sponsor may be more likely to pay benefits on an accelerated basis or to terminate its plan.

[275] ERISA sec. 4011.

can be made available to the public, except for confidential trade secrets and commercial or financial information under FOIA.

Effective date

The proposal is effective for plan years beginning in 2006. The proposal relating to elimination of the nondisclosure rules is effective with respect to filings made under section 4010 of ERISA on or after 30 days after date of enactment.

Analysis

In general

The proposal is intended to provide more detailed and timely information to plan participants, government agencies, and the public regarding the financial status of pension plans and their sponsors and to make such information publicly available. Participants should be adequately and timely informed about their retirement benefits. Many believe that the asset and liability measures under current law do not provide an accurate and meaningful measure to participants of a plan's funding status. They believe that present law does not require adequate disclosure about a plan's funding status and does not provide enough advance warning to participants of underfunding. Some believe that current law results in disclosures being made too late, resulting in participants not being timely informed of the plan status.

Form 5500, Schedule B actuarial statement

The proposal requires the Schedule B actuarial statement filed with the Form 5500 of all single-employer defined benefit pension plans to include the market value of the plan's assets, ongoing liability, and at-risk liability. This will provide participants greater information regarding the financial position of their pension plans, including the increased liability that will result if the financial condition of the plan sponsor deteriorates. Some argue that if a plan sponsor is not financially weak, the Form 5500 should only be required to include the liability applicable to the plan (i.e., ongoing liability), rather than both ongoing and at-risk liability.

The proposal accelerates the deadline for filing of the Schedule B actuarial report in the case of plans that cover more than 100 participants and are subject to the requirement to make quarterly contributions to the 15th day of the second month following the close of the plan year. In the case of a calendar year plan, the due date is February 15. Proponents argue that this will provide timely information on the financial situation of defined benefit pension plans. Others may argue that the accelerated deadline does not provide enough time for completion of the actuarial statement. In the case of plans covering more than 100 participants, the funding proposal previously discussed requires the valuation date to be the first day of the plan year. In such case, the valuation date will be more than one year before the actuarial statement is due.

Summary annual report

The proposal requires the summary annual report to include a presentation of the funding status of the plan for each of the last three years. The funding status must be shown as a percentage based on the ratio of the plan's assets to its funding target. Proponents believe that

requiring disclosure of the plan's funding target, along with a comparison of that liability to the market value of assets, will provide participants more accurate and useful information on the financial status of the plan. The proposal also requires the summary annual report to include information on the company's financial health and on the PBGC guarantee. The proposal is unclear as to what information would be required to show the company's financial health.

The proposal requires that the summary annual report be provided to participants and beneficiaries by 15 days after the filing date for the Form 5500. A penalty is imposed for failure to furnish a summary annual report in a timely manner. Specific information regarding the penalty is unclear. The proposal eliminates the participant notice requirement under section 4011, as the proposal assumes that the summary annual report disclosure will provide more accurate timely information.

Public disclosure of certain PBGC filings

Eliminating the nondisclosure rules of ERISA section 4010(c) allows all information filed with the PBGC pursuant to section 4010 to be available to the public, with the exception of confidential trade secrets and commercial or financial information under FOIA. By eliminating the nondisclosure rule, the proposal is intended to provide more public information on the financial status of pension plans and plan sponsors. The proposal is intended to provide greater information to participants so that they know when their plan is underfunded or when the plan sponsor's financial condition may impair the ability of the company to maintain or fund the plan.

Under the proposal, information disclosed to the PBGC generally is subject to the present-law FOIA provisions. FOIA provides that commercial or financial information that is required to be submitted to the Government is protected from disclosure if it is privileged or confidential.[276] Some argue that FOIA's commercial and financial information exception provides adequate protection for confidential business information. Others believe that certain financial information outside of the scope of the exception should remain confidential.

Public availably of financial information will allow participants more transparency as to the true financial picture of their pensions. The proposal is similar to certain securities laws which require public disclosure of material financial information. Proponents argue that public disclosure of financial information results in greater scrutiny and accountability without requiring the draining of government resources. Some consider public disclosure to be a securities law issue, rather than a pension law issue. Others are concerned that shortfalls in the PBGC insurance program could ultimately become taxpayers' responsibility, so that public disclosure under the pension laws is appropriate.

Some argue that greater public availability is inappropriate as some participants may not have the financial sophistication to appropriately evaluate such information. They also argue

[276] The exception for trade secrets and commercial or financial information also applies for purposes of the Code rule allowing public inspection of written determinations. Sec. 6110(c)(4).

that because the pension system is voluntary, additional requirements on plans and plan sponsors, particularly small employers, may result in some sponsors discontinuing plan sponsorship.

Prior Action

No prior action.

4. Treatment of grandfathered floor-offset plans

Present Law

ERISA generally prohibits defined benefit pension plans from acquiring employer securities or employer real property if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities or employer real property.[277] This 10-percent limitation generally does not apply to most defined contribution plans.[278]

A floor-offset arrangement is an arrangement under which benefits payable to a participant under a defined benefit pension plan are reduced by benefits under a defined contribution plan. The defined benefit pension plan provides the "floor" or minimum benefit which is offset or reduced by the annuitized benefit under the defined contribution plan.

Pursuant to the Pension Protection Act of 1987, the 10-percent limitation on the acquisition of employer securities and employer real property applies to a defined contribution plan that is part of a floor-offset arrangement, unless the floor-offset arrangement was established on or before December 17, 1987. Thus, for floor-offset plans established after that date, the 10-percent limit applies on an aggregated basis to the combined assets of the defined benefit pension plan and the defined contribution plan that form the arrangement.

An employee stock ownership plan (an "ESOP") is an individual account plan that is designed to invest primarily in employer securities and which meets certain other requirements. ESOPs are not subject to the 10-percent limit on the acquisition of employer securities, unless the ESOP is part of a floor-offset arrangement.

Description of Proposal

The exception to the 10-percent limit on holding employer securities and employer real property for plans established on or before December 17, 1987, is eliminated. Floor-offset arrangements affected by the proposal are required to reduce their holdings of employer real

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[277] ERISA sec. 407.

[278] ERISA uses the term "individual account plan" to refer to defined contribution plans. Money purchase pension plans (a type of defined contribution plan) are subject to the 10-percent limitation unless the plan was established before ERISA. Special rules apply with respect to certain plans to which elective deferrals are made.

property and employer securities to no more than 10 percent of the combined assets of both plans over a period of seven years. The requirement to dispose of such property will be phased in pursuant to regulations.

Effective date.–The proposal is effective for plan years beginning after 2005.

Analysis

The present-law 10-percent limit on holding employer securities and real property reflects the concern that assets in defined benefit plans should be adequately diversified and that allowing such plans to hold significant amounts of assets that rely on the financial status of the employer creates a greater risk that the plan will become underfunded in the event of employer financial distress and that benefits under the plan will become the obligation of the PBGC. The potential problems with such arrangements are illustrated by the recent experience with Enron Corporation, which maintained a grandfathered floor-offset arrangement.[279] The proposal addresses this concern by eliminating the grandfather for such arrangements. Thus, all floor-offset plans will be subject to the same rules under the proposal. The proposal recognizes that it may take some time for a plan to dispose of affected property by allowing a seven-year period for plans to comply.

5. Limitations on plans funded below target levels

Present Law

In general

Under present law, various restrictions may apply to benefit increases and distributions from a defined benefit pension plan, depending on the funding status of the plan.

Funding waivers

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.[280] A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers may be granted within any period of 15 consecutive plan years.

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[279] Enron's floor-offset plan and related issues are discussed in Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, at 458-75.

[280] Code sec. 412(d); ERISA sec. 303.

If a funding waiver is in effect for a plan, subject to certain exceptions, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.

Security for certain plan amendments

If a plan amendment increasing current liability is adopted and the plan's funded current liability percentage is less than 60 percent (taking into account the effect of the amendment, but disregarding any unamortized unfunded old liability), the employer and members of the employer's controlled group must provide security in favor of the plan. The amount of security required is the excess of: (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior benefit increases after December 22, 1987, over (2) $10 million.[281] The amendment is not effective until the security is provided.

The security must be in the form of a bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. The security is released after the funded liability of the plan reaches 60 percent.

Prohibition on benefit increases during bankruptcy

Subject to certain exceptions, if an employer maintaining a plan (other than a multiemployer plan) is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.

Liquidity shortfalls

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. If quarterly contributions are required with respect to a plan, the amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall"). In general, a plan has a liquidity shortfall for a quarter if the plan's liquid assets (such as cash and marketable securities) are less than a certain amount (generally determined by reference to disbursements from the plan in the preceding 12 months).

If a quarterly installment is less than the amount required to cover the plan's liquidity shortfall, limits apply to the benefits that can be paid from a plan during the period of underpayment. During that period, the plan may not make: (a) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) in the case of a participant or beneficiary whose annuity starting date occurs during the period; (b) any payment for the purchase of an irrevocable commitment from an

[281] Sec. 401(a)(29).

insurer to pay benefits (e.g., an annuity contract); or (c) any other payment specified by the Secretary of the Treasury by regulations.

Nonqualified deferred compensation

Qualified retirement plans, including defined benefit pension plans, receive tax-favored treatment under the Code. A deferred compensation arrangement that is not eligible for tax-favored treatment is generally referred to as a nonqualified deferred compensation arrangement.[282] In general, a nonqualified deferred compensation arrangement is exempt from the requirements of ERISA only if it is maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. As a result, nonqualified deferred compensation arrangements generally cover only higher paid employees, such as executives.

Nonqualified deferred compensation arrangements may be merely unfunded contractual arrangements, or the employer may establish a trust to hold assets from which nonqualified deferred compensation payments will be made. In some cases, even though trust assets are generally not available for purposes other than to provide nonqualified deferred compensation, the terms of the trust provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy. Such an arrangement is referred to as a "rabbi" trust, based on an IRS ruling issued with respect to such an arrangement covering a rabbi.

Description of Proposal

Restrictions on benefit increases

Under the proposal, the present-law rule prohibiting amendments that increase benefits while the employer is in bankruptcy continues to apply. The present-law rule requiring security for amendments that increase benefits and result in a funded current liability percentage of less than 60 percent is replaced with a new rule. Under the new rule, if the plan's funding percentage (i.e., the market value of the plan's assets as a percentage of the plan's funding target, determined as of the plan's valuation date) does not exceed 80 percent, any amendment increasing benefits is prohibited unless, in addition to the otherwise required minimum contribution, the employer contributes the amount of the increase in the plan's funding target attributable to the amendment. If the plan's funding percentage exceeds 80 percent, but was less than 100 percent for the preceding plan year, an amendment that increases benefits and reduces the plan's funding percentage to less than 80 percent is prohibited unless, in addition to the otherwise required minimum contribution, the employer contributes the lesser of: (1) the amount of the increase in the plan's funding target attributable to the amendment; or (2) the amount needed to increase the plan's funding percentage to 80 percent. If the plan's funding percentage is at least 100 percent, amendments increasing benefits are not restricted. In addition, the restrictions do not apply for the first five years after a plan is established.

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[282] Rules governing nonqualified deferred compensation arrangements are contained in Code section 409A.

Restrictions on distributions and accruals

Under the proposal, the restrictions on distributions during a period of a liquidity shortfall continue to apply (i.e., only annuity payments are permitted). In addition, such restrictions apply if: (1) the plan's percentage does not exceed 60 percent; or (2) in the case of a financially weak employer, the plan's funding percentage does not exceed 80 percent. In addition, no benefit accruals are permitted if: (1) the employer is financially weak and the plan's funding percentage does not exceed 60 percent (i.e., theplan is "severely underfunded"); or (2) the employer is in bankruptcy and the plan's funding percentage is less than 100 percent.

Prohibition on funding nonqualified deferred compensation

Under the proposal, if a financially weak employer maintains a severely underfunded plan, ERISA prohibits the funding of nonqualified deferred compensation for top executives of the employer's controlled group (or any former employee who was a top executive at the time of termination of employment). The proposal also prohibits any funding of executive compensation that occurs within six months before or after the termination of a plan, the assets of which are less than the amount needed to provide all benefits due under the plan. For this purpose, funding includes the use of an arrangement such as a rabbi trust, insurance contract, or other mechanism that limits immediate access to resources of the employer by the employer or by creditors. However, the prohibition on funding nonqualified deferred compensation does not apply for the first five years after a plan is established.

Under the proposal, an employer maintaining a severely underfunded or terminating plan must notify fiduciaries of the plan if any prohibited funding of a nonqualified deferred compensation arrangements occurs. The proposal provides plan fiduciaries with the right to examine the employer's books and records to ascertain whether the employer has met its obligation in this regard.

Under the proposal, a plan has a cause of action under ERISA against any top executive whose nonqualified deferred compensation arrangement is funded during a period when funding is prohibited. The proposal permits the plan to recover the funded amount plus attorney's fees. Plan fiduciaries have the duty to take reasonable steps to pursue the cause of action provided under the proposal.

Timing rules for restrictions

Under the proposal, certain presumptions apply in determining whether restrictions apply with respect to a plan, subject to certifications provided by the plan actuary. If a plan was subject to a restriction for the preceding year, the plan's funding percentage is presumed not to have improved in the current year until the plan actuary certifies that the plan's funding percentage for the current year is such that the restriction does not apply. If a plan was not subject to a restriction for the preceding year, but its funding percentage did not exceed the restriction threshold by more than 10 percentage points, the plan's funding percentage is presumed to be reduced by 10 percentage points as of the first day of the fourth month of the current plan year. As a result, the restriction applies as of that day and until the plan actuary certifies that the plan's funding percentage for the current year is such that the restriction does

not apply. In any other case, if an actuarial certification is not made by the first day of the tenth month of the plan year, as of that day the plan's funding percentage is presumed not to exceed 60 percent for purposes of the restrictions.

If the employer maintaining a plan enters bankruptcy, the plan's funding percentage is presumed to be less than the plan's funding target. As a result, no benefit accruals are permitted until the plan actuary certifies that the plan's funding percentage is at least 100 percent.

For purposes of the timing rules, the actuary's certification must be based on information available at the time of the certification regarding the market value of the plan's assets and the actuary's best estimate of the plan's funding target as of the valuation date for the current plan year. If the actuary determines that the plan's funding percentage using the plan's actual funding target causes a change in the application of restrictions, the actuary must notify the plan administrator of the change.

Notice to participants

If a restriction applies with respect to a plan (including a plan maintained by an employer that enters bankruptcy), the plan administrator must provide notice of the restriction to affected participants within a reasonable time after the date the restriction applies (or, to the extent provided by the Secretary of Labor, a reasonable period of time before the restriction applies). Notice must also be provided within a reasonable period of time after the date the restriction ceases to apply. A plan administrator that fails to provide the required notice is subject to a penalty. The Secretary of Labor is authorized to prescribe regulations relating to the form, content, and timing of the notice.

Restoration of benefits

If restrictions on distributions and accruals apply with respect to plan, distributions and accruals may resume in a subsequent plan year only by a plan amendment. Such an amendment may be adopted at any time after the first valuation date as of which the plan's funding percentage exceeds the applicable threshold, subject to applicable restrictions on plan amendments that increase benefits. In addition, benefits provided under the amendment are subject to the phase-in of the PBGC guarantee of benefit increases.

Effective date

The proposals are generally effective for plan years beginning after December 31, 2006. In the case of a plan maintained pursuant to a collective bargaining agreement in effect on the date of enactment, the proposals are not effective before the first plan year beginning after the earlier of: (1) the date the collective bargaining agreement terminates (determined without regard to any extension thereof); or (2) December 31, 2008.

Analysis

Underfunded plans, particularly those maintained by employers experiencing financial problems, pose the risk that the plan will terminate and the employer will be unable to provide the additional assets needed to provide the benefits due under the plan (a distress termination).

In some cases, because of the limit on the PBGC benefit guarantee, employees bear the cost of underfunding through the loss of benefits. In addition, the PBGC bears the cost of the shortfall to the extent needed to provide guaranteed benefits.

Providing benefit increases under an unfunded plan increases these costs. In addition, the payment of lump sums and similar forms of benefit to some participants drain assets from the plan, thus increasing the cost to the PBGC and other participants. Cases have also arisen in which assets were used to provide nonqualified deferred compensation to corporate executives shortly before bankruptcy and the termination of an underfunded plan covering rank and file employees. The proposal is intended to address these situations by restricting benefit increases, lump sums and similar forms of distribution, and the funding of nonqualified deferred compensation in the case of underfunded plans. Under the proposal, the extent of the restrictions depends on the funding status of the plan and, in some cases, whether the employer is financially weak or has entered bankruptcy.

Some view such restrictions as an appropriate means of limiting the risk presented by underfunded plans. Others may consider some of the restrictions (such as the restriction on lump sums) as unfairly penalizing plan participants and potentially disrupting their retirement income arrangements. Some also suggest that the prospect of being unable to receive lump-sum distributions may itself cause employees to elect lump sums while they are still available, thus triggering a drain on plan assets. On the other hand, some consider it unfair to allow participants to rely on benefits that might never be paid and to favor some participants over others.

With respect to the restriction on funding nonqualified deferred compensation, some may consider it inappropriate to target assets used for that particular purpose without targeting assets used for other purposes. Some also argue that companies in financial difficulty should be able to use competitive compensation methods, including funding methods under which assets will be available to creditors in the event of bankruptcy or insolvency, such as a rabbi trust. Others believe that such funding methods provide executives with the opportunity to cash out their nonqualified deferred compensation before an employer enters bankruptcy, thus giving executives an unfair advantage over rank-and-file participants. Some may also consider it inappropriate to allow a plan to bring action against the executive rather than against the employer. On the other hand, the proposal applies only in the case of a "top" executive. Although the concept of top executive is not defined, it suggests that the proposal is aimed at company officials who have the authority to decide whether to adequately fund the employer's defined benefit pension plan or instead to fund nonqualified deferred compensation benefits.

Prior Action

The President's fiscal year 2005 budget proposal included a proposal to restrict benefit accruals and distributions from certain underfunded plans.

The National Employee Savings and Trust Equity Guarantee Act of 2004, as reported by the Senate Committee on Finance on May 14, 2004, included a provision to restrict benefit increases, benefit accruals, and distributions from financially distressed plans.

6. Eliminate shutdown benefits

Present Law

Unpredictable contingent event benefits

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. Under present law, unpredictable contingent event benefits generally are not taken into account for funding purposes until the event has occurred.

Early retirement benefits

Under present law, defined benefit pension plans are not permitted to provide "layoff" benefits (i.e., severance benefits).[283] However, defined benefit pension plans may provide subsidized early retirement benefits, including early retirement window benefits.[284]

Prohibition on reductions in accrued benefits

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. This restriction is sometimes referred to as the "anticutback" rule and applies to benefits that have already accrued.[285] In general, an amendment may reduce the amount of future benefit accruals, provided that, in the case of a significant reduction in the rate of future benefit accrual, certain notice requirements are met.

For purposes of the anticutback rule, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

Generally, courts have held that unpredictable contingent event benefits are protected by the anticutback rule.[286] Additionally, under proposed Treasury regulations, if an unpredictable

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[283] Treas. Reg. sec. 1.401-1(b)(1)(i).

[284] Treas. Reg. secs. 1.401(a)(4)-3(f)(4) and 1.411(a)-7(c).

[285] Sec. 411(d)(6). Section 204(g) of ERISA provides similar rules for ERISA-covered plans.

[286] See *Bellas v. CBS, Inc.*, 221 F. 3d 517 (3rd Cir. 2000), *cert. denied*, 531 U.S. 1104 (2001) (involuntary separation benefit is both an early retirement benefit and a retirement-type subsidy to the extent it provides for the payment of normal retirement benefits that continue beyond normal retirement age); *Richardson v. Pension Plan of Bethlehem Steel Corp.*, 67 F.3d 1462 (9th Cir. 1995), *withdrawn*, 91 F.3d 1312 (9th Cir. 1996), *modified*, 112 F.3d 982 (9th Cir. 1997) (shutdown benefit is a retirement-type subsidy protected under anticutback rule, opinion

contingent event benefit is a retirement-type subsidy, the benefits cannot be reduced or eliminated with respect to service prior to the applicable amendment date without violating anticutback rule.[287] The proposed regulations, which apply prospectively only, apply this result regardless of whether the contingent event which triggers the payment of the benefit has or has not occurred before the amendment. Thus, under the proposed regulations, protection of unpredictable contingent event benefits which provide retirement-type subsidies is required even before a triggering contingency occurs.

PBGC benefit guarantee

Within certain limits, the PBGC guarantees any retirement benefit that was vested on the date of plan termination (other than benefits that vest solely on account of the termination), and any survivor or disability benefit that was owed or was in payment status at the date of plan termination.[288] Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump sum benefits payable to encourage early retirement) is guaranteed.[289]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that, before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, early retirement benefits provided only if a plant shuts down) are guaranteed only if the triggering event occurs before plan termination.

Description of Proposal

Prohibition on providing unpredictable contingent event benefits

Under the proposal, plans are not permitted to provide benefits which are payable upon a plant shutdown or any similar unpredictable contingent event as determined under regulations.

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withdrawn and modified because court later found plan amendment not valid); *Harms v. Cavenham Forest Industries, Inc.*, 984 F.2d 686 (5th Cir.), *cert. denied*, 510 U.S. 944 (1993) (involuntary separation benefit is a retirement-type benefit protected under the anticutback rule); and *Arena v. ABB Power T&D Company, Inc.*, 2003 U.S. Dist. LEXIS 13166 (S.D. Ind. July 2003) (plant shutdown benefit is a retirement-type subsidy protected by the anticutback rule because the benefit continues beyond normal retirement age and the amount of the benefit exceeds the actuarially reduced normal retirement benefit); but see *Ross v. Pension Plan for Hourly Employees of SKF Industries, Inc.*, 847 F.2d 329 (6th Cir. 1988) (plant shutdown benefit is not a retirement-type subsidy).

[287] Prop. Treas. Reg. sec. 1.411(d)-3(b).

[288] ERISA sec. 4022(a).

[289] ERISA sec. 4022(b) and (c).

A plan which contains such a benefit is required to eliminate the benefit, but only with respect to an event which occurs after the effective date. Such a plan amendment is deemed not to violate the anticutback rule.

Effective date.–The prohibition on providing unpredictable contingent event benefits generally is effective for plan years beginning in 2007. In the case of a collective bargaining agreement which provided for an unpredictable contingent event benefit on February 1, 2005, the prohibition on unpredictable contingent event benefits is not effective before the end of the term of that agreement (without regard any to extension of the agreement) or, if earlier, the first plan year beginning in 2008.

Elimination of PBGC guarantee

The proposal amends the guarantee provisions of Title IV of ERISA to provide that the PBGC guarantee does not apply to benefits that are payable upon a plant shutdown or any similar contingent event.

Effective date.–The elimination of the PBGC guarantee is effective for benefits that become payable as a result of a plant shutdown or similar contingent event that occurs after February 1, 2005.

Analysis

Benefits for plant shutdowns and similar unpredictable contingent events and the PBGC guarantee of such benefits present many issues, including the lack of funding of the benefits and their nature as retirement or severance-type benefits. These issues are relevant with respect to the proposals to eliminate such benefits and the PBGC guarantee.

Unlike most benefits under a defined benefit pension plan, shutdown benefits may be predictable only a short while before the shutdown occurs, to the extent that they can be predicted at all. On the other hand, some shutdowns may be the result of business decisions. Notwithstanding, under the funding rules, a plan's liabilities for shutdown benefits generally remain unfunded until the triggering contingency occurs. After the contingency occurs, the liabilities may be funded over a period of years. In some cases, contingencies may be followed by the employer's insolvency, making it difficult for employers to fully fund the triggered benefits. Additionally, the departure of employees from the company may follow a shutdown or other contingency. Many such employees may take distributions from the plan, thereby draining assets from the plan. If the plan later terminates, assets might not be sufficient to provide the benefits due other plan participants. In addition, the PBGC may be left with increased unfunded liabilities as a consequence of the shutdown and the related benefits. Thus, shutdown benefits may significantly increase the underfunding taken on by the PBGC. Some argue that liabilities for such benefits make up a significant percentage of PBGC losses.

Some view shutdown benefits as severance-type benefits which should not be provided under a retirement plan. Shutdown benefits may, however, be considered a variety of subsidized early retirement benefits, similar to early retirement window benefits which are provided as an incentive for employees to voluntarily terminate employment. Some believe that it is appropriate for a defined benefit pension plan to provide such benefits to employees whose employment is

involuntarily terminated. They argue that concerns about the effect of such benefits on funding status and PBGC liability can be addressed by providing rules under which these benefits are taken into account in determining required contributions and limiting the PBGC guarantee, rather than prohibiting plans from providing the benefits.

Others argue that shutdown benefits which are promised to participants under the terms of a plan should be guaranteed by the PBGC like any other benefits under the plan. Shutdown benefits may represent a significant portion of a participant's benefits under a plan. Moreover, unlike some other types of benefits subject to contingent events, shutdown benefits may be intertwined with the employer's financial well-being. Some feel that eliminating the PBGC guarantee applicable to shutdown benefits might further disadvantage plan participants who are experiencing the effects of their employer's troubled financial status. As an alternative, some suggest that rather than eliminating the PBGC guarantee, the occurrence of an event giving rise to unpredictable contingent event benefits could be treated as a plan amendment, so that the PBGC guarantee of such benefits is phased in over five years.

Prior Action

No prior action.

7. Proposals relating to the Pension Benefit Guaranty Corporation ("PBGC")

(a) Premiums that reflect plan risk

Present Law

In general

The minimum funding requirements permit an employer to fund defined benefit pension plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the PBGC, a corporation within the Department of Labor, was created in 1974 under ERISA to provide an insurance program for benefits under most defined benefit pension plans maintained by private employers.[290] According to the PBGC, as of September 30, 2004, about 34.6 million participants in more than 29,600 single-employer defined benefit pension plans were insured under its programs.[291]

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[290] The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

[291] The PBGC also reported that about 9.8 million participants in approximately 1,600 multiemployer plans were insured under the its programs. Pension Benefit Guaranty Corporation Performance and Accountability Report, Fiscal Year 2004 (Nov. 15, 2004).

Premiums paid to the PBGC

In general

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, premiums paid with respect to covered plans, and investment earnings.

Single-employer plans

All covered single-employer plans are required to pay a flat per-participant premium and underfunded plans are subject to an additional variable premium based on the level of underfunding.

As originally enacted in ERISA, covered plans were annually required to pay a flat premium to the PBGC of $1 per plan participant. The annual flat-rate per-participant premium has been increased several times since the enactment of ERISA and, since 1991, has been $19 per participant.[292]

Under the Pension Protection Act, additional PBGC premiums are imposed on certain plans for plan years beginning after December 31, 1987.[293] In the case of an underfunded plan, additional premiums are required in the amount of $9 per $1,000 of unfunded vested benefits (the amount which would be the unfunded current liability if only vested benefits were taken into account and if benefits were valued at the variable premium interest rate). These premiums are referred to as "variable rate premiums."[294] No variable-rate premium is imposed for a year if contributions to the plan for the prior year were at least equal to the full funding limit for that year. In determining the amount of unfunded vested benefits, the interest rate used is generally 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins (100 percent of the interest rate on 30-year Treasury securities for plan years beginning in 2002 and 2003). Under the Pension Funding Equity Act of 2004,[295] in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes for plan years beginning after December 31, 2003, and before January 1, 2006, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long-term investment-grade corporate bonds for the month preceding the month in which the plan year begins.

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[292] ERISA sec. 4006(a).

[293] Pub. L. No. 100-203 (1987).

[294] If variable rate premiums are required to be paid, the plan administrator generally must provide notice to plan participants of the plan's funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded.

[295] Pub. L. No. 108-218 (2004).

Interest on premium payments

If any premium required to be paid to the PBGC is not paid by the last date prescribed for a payment, interest on the amount of such premium is charged at the rate imposed on underpayment, nonpayment, or extensions of time for payment of tax[296] for the period from such date to the date paid.[297] The PBGC is not authorized to pay interest on premium overpayments.

Description of Proposal

Under the proposal, the single-employer flat-rate premium is increased to $30 starting in 2007 and is indexed annually thereafter based on the Average Wage Index (i.e., the index of the rate of growth of average wages, which is used to adjust the contributions and benefits base under the Social Security Act).

Variable rate premiums are replaced by risk-based premiums, which are charged to all plans with assets less than their funding target (i.e., ongoing liability or at-risk liability, depending on the financial status of the plan sponsor).[298] The risk-based premium is set by the PBGC (and adjusted by the PBGC) are computed based on forecasts of the PBGC's expected claims and future financial condition. The premium rate per dollar of underfunding is uniform for all plans. A plan with a financially-weak sponsor is required to pay premiums for each dollar of unfunded at-risk liability, while a financially-healthy sponsor is required to pay premiums for each dollar of unfunded ongoing liability. The full-funding exception is eliminated so that all underfunded plans are required to pay risk-based premiums. The proposal authorizes the PBGC to pay interest on premium overpayments.

Effective date.–The proposal is effective for plan years beginning on or after January 1, 2006.

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[296] Sec. 6601.

[297] ERISA sec. 4007(b).

[298] For a plan sponsor that is not financially weak, the funding target is the plan's ongoing liability. For a plan sponsor that is financially weak, the funding target generally is the plan's at-risk liability. Ongoing liability and at-risk liability are discussed in the proposal relating to the funding and deduction rules in Part IV.B.2. In general, a plan's ongoing liability for a plan year is the present value of future payments expected to be made from the plan to provide benefits earned as of the beginning of the plan year. At-risk liability is based on the same benefits and assumptions as ongoing liability, except that the valuation of those benefits would require the use of certain actuarial assumptions to reflect the concept that a plan maintained by a financially weak plan sponsor may be more likely to pay benefits on an accelerated basis or to terminate its plan.

Analysis

In general

ERISA requires the pension insurance system to be self-financed, i.e., it is not funded by general revenues. The PBGC's principal sources of revenue are premiums collected from PBGC-covered plans, assets assumed from terminated plans, collection of employer liability payments due under ERISA, and investment income.[299]

The proposal is intended to address problems which are attributed to the current premium structure, including the failure of the present-law premium structure to adequately reflect the risk that an underfunded plan will be terminated, thus shifting costs from financially-troubled companies with underfunded plans to healthy companies with well-funded plans. The premium structure under the proposal is intended to more accurately reflect the exposure that certain defined benefit pension plans present to the pension insurance system. The proposal is also intended to provide increased premium revenue. Premium revenue under the current system is described by the Administration as inadequate to cover expected claims.[300]

As mentioned above, the PBGC premium proposal is one part of the President's overall proposal to increase defined benefit pension plan security. Some argue that the proposed increased flat-rate premium and risk-based premiums may not comprise the most appropriate combination of modifications for alleviating current problems. For example, the proposed increase in the flat-rate premium may be construed as burdening employers which have consistently fully funded their plans with making up for the funding shortfalls of underfunded plans. A more modest increase in premiums may be viewed by some as more fair. Moreover, some feel that the proposal may not solve the problems associated with underfunding of defined benefit pension plans and pension security in general. They believe that the solution may instead be modifications to the funding rules. This is because PBGC premiums may not benefit plan participants to the same extent that funding plans does. Some argue that better funding rules should be enacted and the effects of those rules should be determined before significant premium increases are adopted.

Moreover, if premium increases are viewed as too high by employers, a possible consequence of premium increases may be the freezing of plans by companies which would otherwise maintain ongoing plans. Because sponsoring a retirement plan for employees is voluntary, if the burden of sponsoring a plan becomes too onerous, in part because burdensome premium payments are required, more companies may freeze or terminate defined benefit

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[299] See "Pension Benefit Guaranty Corporation Performance and Accountability Report, Fiscal Year 2004" (Nov. 15, 2004), at 16.

[300] Testimony of Ann L. Combs, Assistant Secretary of Labor, before the Committee on Finance, United States Senate (March 1, 2005), at 16.

pension plans. Further, companies considering whether to establish a defined benefit pension plan may be discouraged from doing so by increased premium costs.[301]

Increase in flat-rate premiums

The proposed increase in the flat-rate premium is intended to reflect wage growth since 1991, when the present-law $19 premium was enacted. This premium increase reflects the idea that the PBGC benefit guarantee has continued to grow with wages since 1991, and the premiums should reflect this increase. The proposed increase in the flat-rate premium reflects a concern that premiums for all covered plans are currently too low.

The proposed premium increase is likely to raise the cost of sponsoring a defined benefit pension plan. As discussed above, whether employers continue to sponsor defined benefit pension plans may be influenced by this increase. Some feel that a more modest increase in the flat-rate premium is a more appropriate alternative to the proposed increase. This, in conjunction with more frequent Congressional review of the premium rate, it is argued, may be a more appropriate way of responding to the conditions affecting defined benefit pension plans.

Indexing of flat-rate premium

Indexing the flat-rate premium using the Average Wage Index is intended to reflect increases in the levels of guaranteed benefits. Increases in wages may affect the level of guaranteed benefits both because the dollar limit on the PBGC guarantee is indexed by reference to wages and because benefits under defined benefit pension plans generally increase as participants' pay increases. For example, benefits are often based on career average or final average pay, or, in the case of a plan which provides a flat rate of benefit, the benefit rate tends to be increased when wage rates are increased. Thus, some feel that the indexing under the proposal is an appropriate means of ensuring a logical correlation between increases in the PBGC's potential liabilities and the revenue it takes in.

Others feel that automatic increases resulting from the indexing of the flat-rate premium diminish the correlation of premiums to the PBGC's actual program costs. Automatic increases resulting from indexing may not reflect the conditions faced by the PBGC. Some believe that under the proposal, premiums may not be as low as possible, representing significant costs to employers.

Risk-based premiums

The present-law variable rate premium is intended to reflect the greater potential risk of exposure from underfunded plans. The variable rate premium is also believed to provide an incentive to plan sponsors to better fund their plans.

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[301] As noted above, some also argue that the current uncertainty with respect to the rules applicable to cash balance plans may also cause employers to freeze defined benefit plans.

The current premium structure is described by the Administration as resulting in the shifting of costs from financially-troubled companies to those with well-funded plans owing to the overdependence on flat-rate premiums and lack of appropriate risk-based premiums. The proposed risk-based premiums are intended to better correlate with the risk a plan poses to the pension insurance system because they are based on a better measure of underfunding and reflect the financial condition of the plan sponsor's controlled group. The periodic adjustment of premium rates based on the PBGC's expected claims and future financial condition, is intended to more accurately reflect the cost of the PBGC program by providing the funds necessary to meet expected future claims and to retire PBGC's deficit over a reasonable time period.

Some express concerns, however, that the proposed risk-based premiums would make financially unstable employers, and those in bankruptcy, liable for substantial premium increases if their plans are not fully funded. An increase in premiums may be a source of volatility and burden for companies struggling to recover from financial hardships. These issues are similar to the issues raised with respect to basing funding requirements on the financial condition of the employer and are discussed in more detail above.

Additionally, some feel that it is not appropriate for the PBGC to set and adjust the risk-based premium, based on forecasts of its expected claims and future financial condition. It may be viewed as more appropriate for the adjustment of risk-based premiums to be subject to Congressional action.

Under the proposal, the risk-based premium is payable even if a plan is at the full funding limit. According to the PBGC, some of the companies maintaining plans that have resulted in the largest claims against the PBGC insurance fund have not been required to pay a variable rate premium because they were at the full funding limit.[302] Imposing the risk-based premium on plans that are at the full funding limit will subject more plans to the premium compared to the present-law variable rate premium. The present-law exception for plans at the full funding limit reflects concerns that it may be unfair to impose the premium on employers making contributions up to certain levels, even if the plan remains underfunded. Under the proposal, contributions to eliminate underfunding are fully deductible, so that an employer may avoid the risk-based premium by making sufficient contributions to eliminate underfunding. In some cases, the amount of contributions required to eliminate underfunding could be substantial.

Interest on premium overpayments

Some believe that premium payers should receive interest on premium overpayment amounts that are owed to them. Others feel that it is inappropriate for the PBGC to pay interest and that providing for such interest may further impair the financial condition of the PBGC. Some argue that interest may not be appropriate in some cases, depending on how the overpayment arose.

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[302] Testimony of Bradley D. Belt, Executive Director, Pension Benefit Guarantee Corporation, before the Committee on Finance, United States Senate (March 1, 2005) at 15.

Prior Action

No prior action.

(b) Freeze benefit guarantee when contributing sponsor enters bankruptcy

Present Law

Termination of single-employer defined benefit pension plans

In general

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination.[303] The participants and the PBGC must be provided notice of the intent to terminate. The PBGC may also involuntarily terminate a plan (that is, the termination is not voluntary on the part of the employer).

Standard terminations

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities.[304] Generally, benefit liabilities equal all benefits earned to date by plan participants, including vested and nonvested benefits (which automatically become vested at the time of termination), and including certain early retirement supplements and subsidies.[305] Benefit liabilities may also include certain contingent benefits (for example, early retirement subsidies). If assets are sufficient to cover benefit liabilities (and other termination requirements, such as notice to employees, have not been violated), the plan distributes benefits to participants. The plan provides for the benefit payments it owes by purchasing annuity contracts from an insurance company, or otherwise providing for the payment of benefits, for example, by providing the benefits in lump-sum distributions.

If certain requirements are satisfied, and the plan so provides, assets in excess of the amounts necessary to cover benefit liabilities may be recovered by the employer in an asset reversion. Reversions are subject to an excise tax, described above.

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[303] ERISA sec. 4041.

[304] *Id.*

[305] ERISA sec. 4001(a)(16).

Distress terminations and involuntary terminations by the PBGC

Distress terminations

If assets in a defined benefit pension plan are not sufficient to cover benefit liabilities, the employer may not terminate the plan unless the employer meets one of four criteria necessary for a ''distress'' termination:

- The contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings;
- The contributing sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding;
- The PBGC determines that termination is necessary to allow the employer to pay its debts when due; or
- The PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer's work force.[306]

These requirements, added by the Single Employer Pension Plan Amendments Act of 1986[307] and modified by the Pension Protection Act of 1987[308] and the Retirement Protection Act of 1994,[309] are designed to ensure that the liabilities of an underfunded plan remain the responsibility of the employer, rather than of the PBGC, unless the employer meets strict standards of financial need indicating genuine inability to continue funding the plan.

Involuntary terminations by the PBGC

The PBGC may institute proceedings to terminate a plan if it determines that the plan in question has not met the minimum funding standards, will be unable to pay benefits when due, has a substantial owner who has received a distribution greater than $10,000 (other than by reason of death) while the plan has unfunded nonforfeitable benefits, or may reasonably be expected to increase PBGC's long-run loss unreasonably. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.

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[306] ERISA sec. 4041.

[307] Pub. L. No. 99-272 (1986).

[308] Pub. L. No. 100-203 (1987).

[309] Pub. L. No. 103-465 (1994).

Asset allocation

ERISA contains rules for allocating the assets of a single-employer plan when the plan terminates.[310] Plan assets available to pay for benefits under a terminating plan include all plan assets remaining after subtracting all liabilities (other than liabilities for future benefit payments), paid or payable from plan assets under the provisions of the plan. On termination, the plan administrator must allocate plan assets available to pay for benefits under the plan in the manner prescribed by ERISA. In general, plan assets available to pay for benefits under the plan are allocated to six priority categories.[311] If the plan has sufficient assets to pay for all benefits in a particular priority category, the remaining assets are allocated to the next lower priority category. This process is repeated until all benefits in the priority category are provided or until all available plan assets have been allocated.[312]

Guaranteed benefits

Single-employer plans

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump-sum benefits payable to encourage early retirement) is guaranteed.[313]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, subsidized early retirement benefits) are guaranteed only if the triggering event occurs before plan termination.

For plans terminating in 2005, the maximum guaranteed benefit for an individual retiring at age 65 is $3,698.86 per month or $44,386.32 per year.[314] The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

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[310] ERISA sec. 4044(a).

[311] *Id.*

[312] The asset allocation rules also apply in standard terminations.

[313] ERISA sec. 4022(b) and (c).

[314] The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.[315]

Description of Proposal

Under the proposal, the amount of guaranteed benefits payable by the PBGC is frozen when a contributing sponsor enters bankruptcy or a similar proceeding. The freeze continues for two years after the sponsor emerges from bankruptcy. If the plan terminates during the contributing sponsor's bankruptcy or within two years after the sponsor emerges from bankruptcy, the amount of guaranteed benefits payable by the PBGC is determined based on plan provisions, salary, service, and the guarantee in effect on the date the employer entered bankruptcy.

The priority among participants for purposes of allocating plan assets and employer recoveries to non-guaranteed benefits in the event of plan termination is determined as of the date the sponsor enters bankruptcy or a similar proceeding.

The administrator of a plan for which guarantees are frozen is required to notify plan participants about the limitations on benefit guarantees, and potential receipt of non-guaranteed benefits in a termination on account of the bankruptcy.

Effective date.–The proposal is effective with respect to Federal bankruptcy or similar proceedings or arrangements for the benefit of creditors which are initiated on or after the date that is 30 days after enactment.

Analysis

A recent report of the Government Accountability Office said that the termination of large, underfunded defined benefit pension plans of bankruptcy firms in troubled industries has been the major cause of the PBGC's single employer program's worsening net financial

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assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

Special rules limit the guaranteed benefits of individuals who are substantial owners covered by a plans whose benefits have not been increased by reason of any plan amendment. A substantial owner generally is an individual who: (1) owns the entire interest in an unincorporated trade or business; (2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in the partnership; (3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of the corporation or all the stock of the corporation; or (4) at any time within the preceding 60 months was a substantial owner under the plan. ERISA sec. 4022(b)(5).

[315] The phase in does not apply if the benefit is less than $20 per month.

position.[316] The PBGC estimates that financially-weak firms, particularly in the airline industry, sponsor plans with over $35 billion in unfunded benefits.[317]

A PBGC-insured defined benefit pension plan may be terminated during the pendency of the plan sponsor's bankruptcy. During bankruptcy, plan assets may be diminished because the plan sponsor's ability to make contributions to the plan may be compromised. Additionally, distributions to participants during bankruptcy may decrease plan assets. The PBGC's losses attributable to paying guaranteed benefits which are unfunded may worsen if plan assets are decreased during bankruptcy. In cases where assets of a plan which is terminated are not sufficient to cover benefit liabilities, the PBGC is required to pay benefits within prescribed limits to participants. Any increases in PBGC-guaranteed benefit amounts apply to benefits under a plan until it is terminated.

Using the date a plan sponsor enters bankruptcy as the determinative date for freezing the amount of guaranteed benefits and setting the priority for purposes of plan asset allocation and employer recoveries of non-guaranteed benefits may decrease the PBGC's losses for unfunded guaranteed benefits. Some feel that the date a plan sponsor files a bankruptcy petition is the appropriate measure for setting PBGC-guaranteed benefit levels and priorities for asset allocations. Using this date, it is argued, would more effectively and appropriately limit the PBGC's exposure for unfunded liabilities. Drains on plan assets and increases in unfunded liabilities which may arise during the period after the bankruptcy petition is filed and before termination of the plan may no longer result in disproportionate losses for the PBGC. For these same reasons, some argue that the bankruptcy filing date is the appropriate date for allocating assets to priority categories.

On the other hand, freezing the amount of PBGC-guaranteed benefits on the date a plan sponsor enters bankruptcy and maintaining the freeze for two years after the plan sponsor emerges from bankruptcy may be viewed as unfair to plan participants. Plan sponsors may be in bankruptcy for years; an additional two years may exacerbate the negative impact on plan participants. The guaranteed benefits paid by the PBGC to participants whose plans are terminated already may be considerably lower than the benefits they were promised under the plan terms under present law. Freezing the level of benefits provided by the PBGC as of the date of the bankruptcy petition may further harm participants.

Prior Action

No prior action.

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[316] GAO, High-risk Series: An Update, GAO-05-207 (Washington, D.C.: January 2005).

[317] *Id.*

(c) Allow PBGC to perfect liens in bankruptcy for missed required pension contributions

Present Law

Funding rules

The Code and the ERISA impose both minimum funding requirements with respect to defined benefit pension plans.[318] Under the minimum funding rules, the amount of contributions required for a plan year ("minimum required contributions") is generally the plan's normal cost for the year (i.e., the cost of benefits allocated to the year under the plan's funding method) plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. In general, plan contributions required to satisfy the funding rules must be made within 8-1/2 months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

A plan with a funded current liability percentage of less than 100 percent for the preceding plan year must make estimated contributions for the current plan year in quarterly installments ("installment payments") during the current plan year. A plan's "funded current liability percentage" is the actuarial value of plan assets (i.e., the average fair market value over a period of years) as a percentage of the plan's current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan.

PBGC liens for missed contributions

Under certain conditions, if an employer fails to timely make a required installment payment or minimum required contribution to a defined benefit pension plan (other than a multiemployer plan), a lien automatically arises in favor of the plan.[319] For such a lien to arise, (1) the plan's current liability percentage must be less than 100 percent for the plan year; (2) the plan must be covered by the PBGC termination insurance program; (3) the installment payment minimum required contribution was not made before the due date for the contribution; and (4) the unpaid balance of the installment payments or required minimum contributions (including interest), when added to the aggregate unpaid balance of all preceding installment payments or minimum required contributions which were not paid before the due date (including interest) exceeds $1,000,000.

The lien is upon all property and rights to property, whether real or personal, belonging to the employer or a member of the employer's controlled group.[320] The amount of the lien is equal

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[318] Code sec. 412; ERISA sec. 302.

[319] Code sec. 412(n); ERISA sec. 302(f).

[320] The term "controlled group" means any group treated as a single employer under subsections (b), (c), (m) or (o) of Code section 414.

to the aggregate unpaid balance of required contributions (including interest) for plan years beginning after 1987 and for which payment has not been made before the due date for the installment payment or required minimum contribution.

The lien arises after the due date for which the installment payment or minimum required contribution is not made and continues through the end of the plan year in which such liabilities exceed $1,000,000. The PBGC may perfect[321] and enforce such a lien, or such a lien may be perfected and enforced at the direction of the PBGC by the contributing sponsor or any member of the controlled group of the contributing sponsor.

Bankruptcy rules affecting liens for missed contributions

Automatic stays

Federal bankruptcy law provides for provides for an automatic stay against certain actions by creditors once a bankruptcy petition is filed.[322] The automatic stay prevents the commencement or continuation of actions against the debtor or the debtor's property and applies to all entities, including governmental entities. The automatic stay protects the debtor's property against attempts to create, perfect, or enforce liens against it, including liens which arise solely by force of a statute on specified circumstances or conditions ("statutory liens").[323] The automatic stay generally remains in effect, absent modification or termination by the court, until the earliest of (1) the time the case is closed; (2) the time the case is dismissed; or (3) the time a discharge is granted or denied.

The automatic stay applies to PBGC liens for missed contributions.

Lien avoidance powers

Federal bankruptcy law allows a bankruptcy trustee[324] to avoid statutory liens that are not perfected or enforceable against a hypothetical bona fide purchaser as of the date of the

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[321] When a creditor has taken the required steps to perfect a lien, that lien is senior to any liens that arise subsequent to the perfection. An unperfected lien is valid between the debtor and the creditor, but in the context of a bankruptcy proceeding, an unperfected lien may be treated as behind liens created later in time, but perfected earlier. An unperfected lien can be avoided in bankruptcy. State law generally applies to perfection of liens. A lien generally may be perfected in various ways, including by filing or recording with various government offices.

[322] 11 U.S.C. sec. 362 (2005).

[323] 11 U.S.C. sec. 101(38) (2005).

[324] The bankruptcy trustee is the representative of the debtor's estate. The estate is generally is comprised of the legal or equitable interests of the debtor as of the filing of the petition for bankruptcy. See 11 U.S.C. secs. 323 and 541 (2005).

bankruptcy petition is filed.[325] This power generally allows a bankruptcy trustee to avoid liens for missed contributions which are not perfected by the PBGC at the time a bankruptcy petition is filed.

Description of Proposal

The proposal amends Federal bankruptcy law to provide an exemption from the automatic stay under Federal bankruptcy law to allow the creation and perfection of PBGC liens for missed contributions against a plan sponsor and controlled group members. The proposal also provides an exemption for PBGC liens for missed contributions from the lien avoidance provisions of Federal bankruptcy law.

Effective date.–The proposal is effective with respect to initiations of Federal bankruptcy or similar proceedings on or after the date 30 days after enactment.

Analysis

Federal bankruptcy law allows a debtor to preserve some of its assets and discharges the debtor's legal obligation to pay certain debts. In many cases, bankruptcy allows a debtor the chance to cure its financial ills and continue in business. The automatic stay, a fundamental feature of the protections afforded a debtor under Federal bankruptcy law, provides the debtor relief from collection efforts by creditors and protects the bankruptcy estate from being depleted and from seizures of property before the bankruptcy trustee has marshaled and distributed the debtor's assets. The lien avoidance provisions under Federal bankruptcy law grant special protections to the debtor in certain cases, allowing a bankruptcy trustee to avoid creditor's claims. Like other creditors, the PBGC is subject to these provisions as they apply to a plan sponsor which has petitioned for bankruptcy.

It may be argued that that the automatic stay and lien avoidance provisions of Federal bankruptcy law unfairly allow employers to escape liability for required contributions to defined benefit pension plans. The PBGC may be adversely affected as a result. An employer with significant aggregate unpaid required installment payments or minimum required contributions may avoid its funding obligations as to the missed contributions during the pendency of a bankruptcy proceeding. If a plan terminates while the employer is in bankruptcy, the PBGC may experiences losses on account of its inability to perfect liens for missed contributions and the lien avoidance rules which may allow the trustee to avoid the PBGC lien. Some feel that that the PBGC lien for missed contributions should not be made ineffective by a plan sponsor's entering bankruptcy notwithstanding whether it has been perfected. In many cases, an employer's

[325] 11 U.S.C. sec. 545(2) (2005). Statutory liens may also be avoided to the extent that the lien first becomes effective against the debtor: (1) when a bankruptcy case is commenced; (2) when an insolvency proceeding other than under bankruptcy law is commenced; (3) when a custodian is appointed or authorized to take or takes possession; (4) when the debtor becomes insolvent; (5) when the debtor's financial condition fails to meet a specified standard; or (6) at the time of an execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien. 11 U.S.C. sec. 545(1) (2005).

liability for unpaid contributions later become unfunded liabilities which are taken on by the PBGC once the plan is terminated.

On the other hand, the automatic stay and lien avoidance provisions assist in preserving Federal bankruptcy law's distributional scheme for distributing the debtors' assets. These provisions generally allow the trustee to take stock of the debtor's property interests so as to be apprised of the various rights and interests involved without the threat of immediate estate dismemberment by zealous creditors. Additionally, they prevent creditors from gaining preference, forestall the depletion of a debtor's assets, and avoid interference with or disruption of the administration of the bankruptcy estate in an orderly liquidation or reorganization. It may be argued that exempting PBGC liens for missed contributions from these provisions would interfere with these fundamental principles of Federal bankruptcy law and may ultimately harm the interests of defined benefit pension plan participants, for example, by making it more difficult for the employer to emerge from bankruptcy.

Some feel that a more appropriate solution to obstacles the PBGC encounters when a plan sponsor enters bankruptcy is to modify the non-bankruptcy laws which affect PBGC's financial position, including the funding rules.

Prior Action

No prior action.

C. Reflect Market Interest Rates in Lump-Sum Payments

Present law

Accrued benefits under a defined benefit pension plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form. Defined benefit pension plans generally provide that a participant may choose among other forms of benefit offered under the plan, such as a lump-sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.

A defined benefit pension plan must specify the actuarial assumptions that will be used in determining optional forms of benefit under the plan in a manner that precludes employer discretion in the assumptions to be used. For example, a plan may specify that a variable interest rate will be used in determining actuarial equivalent forms of benefit, but may not give the employer discretion to choose the interest rate.

Statutory assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum.[326] That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to the life annuity payable to the participant, determined using the statutory assumptions. The statutory assumptions consist of an applicable mortality table (as published by the IRS) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of the time that is permitted under regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant ("stability period") and the use of averaging.

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $170,000 (for 2005).[327] The dollar limit generally applies to a benefit payable in the form of a straight life annuity. If the benefit is not in the form of a straight life annuity (e.g., a lump sum), the benefit generally is adjusted to an equivalent straight life annuity. For purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) the rate applicable in determining minimum lump sums, i.e., the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan. In the case of plan years beginning in 2004 or 2005, the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan.

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[326] Code sec. 417(e)(3); ERISA sec. 205(g)(3).

[327] Code sec. 415(b).

Description of Proposal

The proposal changes the interest rate used to calculate lump sums payable from a defined benefit pension plan.

For plan years beginning in 2005 and 2006, the proposal does not change the law relating to the determination of minimum lump sums from defined benefit pension plans (i.e., minimum lump-sum values are determined using the rate of interest on 30-year Treasury securities). Beginning in 2009, the proposal provides that minimum lump-sum values are to be calculated using rates drawn from the zero-coupon corporate bond yield curve. Under the proposal, the yield curve is to be issued monthly by the Secretary of Treasury and based on the interest rates (averaged over 90 business days) for high quality corporate bonds with varying maturities. Thus, the interest rate that applies depends upon how many years in the future a participant's annuity payment will be made. Typically, a higher interest applies for payments made further out in the future.

For distributions in 2007 and 2008, lump-sum values are determined as the weighted average of two values: (1) the value of the lump sum determined under the methodology under present law (the "old" methodology); and (2) the value of the lump sum determined using the methodology applicable for 2009 and thereafter (the "new" methodology). For distributions in 2007, the weighting factor is 2/3 for the lump-sum value determined under the old methodology and 1/3 for the lump-sum value determined under the new methodology. For distributions in 2008, the weighting factors are reversed.

Analysis

As previously discussed, recent attention has focused on the issue of the rate of interest used to determine the present value of benefits under defined benefit pension plans for purposes of the plan's current liability and the amount of lump-sum benefits under the plan.[328] Under present law, the interest rate used for valuing lump-sum benefits is based on the interest rate on 30-year Treasury obligations. The interest rate issue has received attention recently in part because the Treasury Department stopped issuing 30-year obligations. As a result, there is no longer a 30-year Treasury interest rate (the interest rate for the Treasury bond due on February 15, 2031, is used), and statutory changes are necessary to reflect this. In addition, as discussed below, concerns have been raised that the 30-year Treasury rate was too low compared to annuity purchase rates and therefore caused inappropriate results.

Because minimum lump-sum distributions are calculated as the present value of future benefits, the interest rate used to calculate this present value will affect the value of the lump-sum benefit. Specifically, the use of a lower interest rate results in larger lump-sum benefits; the use of a higher interest rate results in lower lump-sum benefits.

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[328] The President's proposal relating to the interest rate to be used to determine a plan's liability is discussed in Part IV.B.2.

Some have argued that the 30-year Treasury rate has been so low as to make lump-sum benefits disproportionately large in comparison with a life annuity benefit payable under the plan, thus providing an incentive for employees to take benefits in a lump sum rather than in the form of a life annuity. Some argue that lump sums should not be favored as a form of benefit because they can cause a cash drain on the plan. In addition, an annuity assures the individual of an income stream during retirement years, which may not be available in the case of a lump-sum payment, depending on what use the individual makes of the payment (e.g., whether the individual spends the lump sum currently or uses the funds to purchase an annuity).

Under the proposal, the rate of interest on 30-year Treasury securities is replaced with the rate of interest on high-quality corporate bonds for purposes of determining a plan's minimum lump-sum values. In determining lump-sum values, the proposal provides for the use of a series of interest rates drawn from a yield curve of high-quality zero-coupon bonds with various maturities, selected to match the timing of benefit payments expected to be made from the plan.

Some have raised concerns that a yield-curve approach is more complicated than the use of a single rate, particularly for purposes of determining lump-sum distributions. Others argue that it is unlikely that use of a yield curve would introduce new complexities for plan administrators, as the most complicated aspect of determining the present value of a plan's future liabilities is the determination of the magnitude and timing of future liabilities themselves, which is not affected by the proposal. Once the future stream of liabilities is projected, the difference in difficulty between discounting using one rate for each year, or discounting with varying rates (i.e., the yield curve), is trivial.

Some believe that the same rate should be used for determining the plan's current liability and amount of lump-sum benefits under the plan, while others argue that the use of different rates may be appropriate. Even though the 30-year Treasury rate is used for both purposes under present law, different averaging periods apply. The interest rates used for the two purposes at any particular time are not necessarily the same.

The proposal includes a transition period so that employees who are expecting to retire in the near future are not subject to a change in the expected amount of their lump sum. While most agree that a transition period is necessary, views differ on the appropriate length of the transition period.

The proposal does not directly change the rules under section 415 for the limitations on annual benefits. As discussed above, in applying these limitations to lump-sum benefits, the interest rate that must be used must be not less than the greater of (1) the interest rate used in determining minimum lump sums,[329] or (2) the interest rate used in the plan. Because section 415 refers to the rate applicable in determining minimum lump sums, the proposal to change the rate used for minimum lump-sum purposes would automatically apply for purposes of applying the limits on benefits to lump sums. In addition, many plans use the applicable rate under

[329] For 2004 and 2005, 5.5 percent is used in lieu of the interest rate used in determining minimum lump sums. However, the proposal is not effective until after such years.

section 417(e) to determine lump-sum benefits. In such a case, the proposal to use a corporate bond yield curve in determining minimum lump sums has the effect of also making the corporate bond yield curve the rate used in the plan. Thus, the proposal indirectly affects the computation of the annual limit on benefits.

Prior Action

A similar proposal was included in the President's fiscal year 2005 budget proposal.

The National Employee Savings and Trust Equity Guarantee Act of 2004 ("NESTEG"), as reported by the Senate Committee on Finance on May 14, 2004, included a provision relating to the interest rate used to determine minimum lump-sum benefits. Under that provision, for plan years beginning in 2007 through 2010, a phase-in yield curve method generally applies in determining the amount of a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit. The yield curve is based on interest rates on high-quality corporate bonds. For plan years beginning after 2010, the yield curve method generally applies in determining the amount of a benefit in a form that is subject to the minimum value rules.

V. TAX SHELTERS, ABUSIVE TRANSACTIONS, AND TAX COMPLIANCE

A. Combat Abusive Foreign Tax Credit Transactions

Present Law

The United States employs a "worldwide" tax system, under which residents generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the possibility of double taxation arising from overlapping claims of the United States and a source country to tax the same item of income, the United States provides a credit for foreign income taxes paid or accrued, subject to several conditions and limitations.

For purposes of the foreign tax credit, regulations provide that a foreign tax is treated as being paid by "the person on whom foreign law imposes legal liability for such tax."[330] Thus, for example, if a U.S. corporation owns an interest in a foreign partnership, the U.S. corporation can claim foreign tax credits for the tax that is imposed on it as a partner in the foreign entity. This would be true under the regulations even if the U.S. corporation elected to treat the foreign entity as a corporation for U.S. tax purposes. In such a case, if the foreign entity does not meet the definition of a controlled foreign corporation or does not generate income that is subject to current inclusion under the rules of subpart F, the income generated by the foreign entity might never be reported on a U.S. return, and yet the U.S. corporation might take the position that it can claim credits for taxes imposed on that income. This is one example of how a taxpayer might attempt to separate foreign taxes from the related foreign income, and thereby attempt to claim a foreign tax credit under circumstances in which there is no threat of double taxation.

Description of Proposal

The proposal provides regulatory authority for the Treasury Department to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income in cases in which taxes are imposed on any person in respect of income of an entity. Regulations issued pursuant to this authority could provide for the disallowance of a credit for all or a portion of the foreign taxes, or for the allocation of the foreign taxes among the participants in the transaction in a manner more consistent with the economics of the transaction.

Effective date.–The proposal generally is effective after the date of enactment.

Analysis

The proposal expands existing regulatory authority to facilitate efforts on the part of the Treasury Department and the IRS to address abusive transactions involving foreign tax credits.[331] The proposal gives the Treasury Department broad authority to stop foreign tax credit abuses, but the proposal does not identify in great detail the scope of transactions that would be covered.

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[330] Treas. Reg. sec. 1.901-2(f)(1).

[331] See, e.g., Notices 2004-19 and 2004-20, 2004-11 I.R.B. 1.

The effectiveness of these rules would depend on the degree to which the Treasury Department provides greater detail with respect to the scope of transactions covered and the means by which these transactions would be curtailed.

Prior Action

This proposal was included in H.R. 4520, the American Jobs Creation Act of 2004, as passed by the Senate. The proposal was not included in AJCA as enacted.

This proposal also was included in the President's fiscal year 2005 budget proposal.

B. Modify the Active Trade or Business Test for Certain Corporate Divisions

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value.[332] In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.[333]

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution. If the requirements are satisfied, section 355 provides tax-free treatment both to pro-rata distributions of stock of a subsidiary to the parent's shareholders and also to non-pro-rata distributions, in which the former parent company shareholders own the distributed and former parent corporations in different proportions after the transaction. In these cases, one or more former parent shareholders not only may own the resulting corporations in different proportions after the transaction than their ownership in the parent prior to the transaction, but also might terminate any stock relationship in one or the other of the corporations.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active trade or business test").[334] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all its assets consist of stock and securities of one or more corporations that it controls immediately after the distribution, each of which is engaged in the active conduct of a trade or business.[335]

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[332] Secs. 311(b) and 336.

[333] Secs. 301 and 302.

[334] Sec. 355(b). Certain taxable acquisitions that are considered expansions of an existing active trade or business are not treated as the taxable acquisition of a business for purposes of the rules. Treas. Reg. sec. 1.355-3(b)(3)(ii) and sec. 1.355-3(c), Examples (7) and (8).

[335] Sec. 355(b)(2)(A). The IRS takes the position for advance ruling purposes that the second statutory test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

There is no statutory requirement that a certain percentage of the distributing or controlled corporation's assets be used in the conduct of an active trade or business in order for the active trade or business test to be satisfied.

In determining for advance ruling purposes whether a corporation is directly engaged in an active trade or business that satisfies the requirement, prior IRS guidelines required that the fair market value of the gross assets of the active trade or business ordinarily must constitute at least five percent of the total fair market value of the gross assets of the corporation.[336] The IRS recently suspended this specific rule in connection with its general administrative practice of devoting fewer IRS resources to advance rulings on factual aspects of section 355 transactions.[337]

Description of Proposal

Under the proposal, in order for a corporation to satisfy the active trade or business test in the case of a non-pro-rata distribution, as of the date of the distribution at least 50 percent of its assets, by value, must be used or held for use in a trade or business that satisfies the active trade or business test.

Effective Date

No effective date for the proposal is specified in the President's budget proposal. For revenue estimating purposes, the staff of the Joint Committee on Taxation has assumed the provision to be effective for distributions made on or after the date of enactment.

Analysis

The purpose of section 355 is to permit existing shareholders to separate existing businesses for valid business purposes without immediate tax consequences. Absent section 355, a corporate distribution of property (including stock of a subsidiary) to shareholders would be a taxable event both to the distributing corporation and to the shareholders.

Present law arguably has permitted taxpayers to use section 355 as a vehicle to make, in effect, tax- free distributions of large amounts of cash by combining a relatively small business with such cash in a distributed corporation. Recent press reports have referred to these transactions as "cash-rich" tax-free corporate divisions.[338] For example, the addition of a

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[336] The ruling guidelines also provided the possibility that the IRS might rule the active trade or business test was satisfied if the trades or businesses relied upon were not "de minimis" compared with the other assets or activities of the corporation and its subsidiaries. Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[337] Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

[338] In one of the reported recent transactions, the Clorox Company distributed $2.1 billion cash and a business worth $740 million to a U.S. subsidiary of the German company Henkel KGaA in redemption of that subsidiary's 29 percent interest in Clorox. Other reported transactions were undertaken by Janus Capital Group and DST Systems, Inc. (with cash

relatively small business to an otherwise cash stock redemption transaction can convert an essentially cash stock buyback, which would have been taxed to the recipient shareholder, into a tax-free transaction for the recipient shareholder. Increasing the active business asset requirement to a level such as 50 percent in the case of a non-pro-rata distribution could provide some limit to the proportion of cash that can be distributed in such transactions.

The 50-percent active trade or business test of the proposal could be criticized as inadequate to accomplish its policy objectives, since the proposal still permits at least 50 percent of assets to be mere investment assets or cash that are neither used nor held for use in the active conduct of a trade or business.[339] Consideration could be given to increasing the threshold above 50 percent. For example, present law requires that 80 percent of gross assets by value be "used" in the active conduct of one or more qualified trades or businesses for favorable tax treatment of investments in certain small business corporations, with specific statutory definitions of what is considered "use" for this purpose.[340]

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representing 89 percent of the value of the distributed corporation); Houston Exploration Company and KeySpan Corp. (87 percent cash); and Liberty Media Corporation and Comcast Corporation (53 percent cash). See, e.g., Allan Sloan, "Leading the Way in Loophole Efficiency," *Washington Post,* (October 26, 2004), at E.3; Robert S. Bernstein, "Janus Capital Group's Cash Rich Split-Off," *Corporate Taxation*, (November-December 2003) at 39; Robert S. Bernstein, "KeySpan Corp.'s Cash-Rich Split Off," Corporate Taxation, (September-October 2004) at 38. Robert Willens, "Split Ends," *Daily Deal*, (August 31, 2004); and Richard Morgan, "Comcast Exits Liberty Media," *Daily Deal,* (July 22, 2004). See also, The Clorox Company Form 8-K SEC File No. 001-07151), (October 8, 2004); Janus Capital Group, Inc. Form 8-K (SEC File No. 001-15253) (August 26, 2003); The Houston Exploration Company Form 8-K (SEC File No. 001-11899) (June 4, 2004); Key Span Corp. Form 8-K (SEC File No. 001-14161 (June 2, 2004); and Liberty Media Corporation Form 8-K (SEC File No. 001-16615) (July 21, 2004).

[339] The proposal does not explicitly define the situations in which various types of assets could qualify under the test as "used or held for use" in an active trade or business. Thus, it is unclear whether, or to what extent, the proposal categorically would preclude investment assets or cash from being considered such assets. *See* additional discussion of these issues in the following text.

[340] Secs. 1202(c)(2), 1202(e)(1)(A), and 1045(b). For purposes of this 80-percent test, the statute expressly provides that assets are treated as used in the active conduct of a trade or business if they are held as part of the reasonably required working capital needs of a qualified trade or business or if they are held for investment or are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business. However, for periods after the corporation has been in existence for at least two years, no more than 50 percent of the assets of the corporation can qualify as used in the active conduct of a trade or business by reason of these provisions. Sec. 1202(e)(6).

In some cases, it is possible that an active trade or business might require large amounts of cash or other investment assets to prepare for upcoming business needs. The proposal does appear to give some leeway for such situations by permitting assets "held for use" in the active conduct of a trade or business to count towards the 50-percent requirement. While the intended scope of this "held for use" standard is not entirely clear, it is possible that it would be interpreted at least to cover working capital needs of the business and possibly broader expansion or other needs. The test might also be interpreted to provide the necessary flexibility to address, for example, situations involving financial institutions or insurance companies that might hold significant investment-type assets as part of their business. Specific clarification of the intended scope of the phrase could be desirable, both from the viewpoint of the government and of taxpayers. On the one hand, expressly stating any limitations might provide a more administrable limit on the extent to which a taxpayer can assert possible expansion or other potential plans to justify a very high percentage of cash or investment assets. On the other hand, even if that phrase is limited in any way to provide greater certainty, from the taxpayer's point of view there would appear to be significant leeway for additional cash and investment assets, since half the entire value of the entity can consist of cash or other assets that are neither used nor held for use in the active conduct or a trade or business.

Some may argue that any significant absolute cut-off test might prove inflexible in accommodating situations where corporations legitimately need to equalize values to shareholders in a division of business assets. However, if cash in excess of 50 percent of the assets transferred is necessary to equalize values, the question arises whether such an amount of cash should be allowed to be transferred tax-free. A corporation could distribute the excess cash prior to the division if necessary, keeping the basic business division tax-free but causing a taxable event to shareholders who are being economically cashed out in part in connection with the business division.

It also might be argued that in corporate divisions such as those affected by the proposal, the distributed cash or investment assets remain in corporate solution and thus have not been paid directly to the shareholder. However, in such situations, the value of such cash or investment assets may be very accessible to the shareholder even without a further distribution. A divisive transaction has occurred that has qualitatively changed the shareholder's investment by separating the cash from the assets in which the shareholder had previously invested. Such a transaction may allow the shareholder indirectly to obtain the value of the cash in the separated corporation, by borrowing against stock that carries little business risk.

Similarly, it could be argued that as long as the assets in question have a carryover basis in the hands of the corporation, it is not necessary to impose a tax at the time of distribution of the corporate stock. However, a corporation generally is not permitted to sell assets to another corporation at carryover basis without tax; nor is a corporation generally permitted to distribute stock of a subsidiary without tax (absent the application of section 355). Moreover, section 355 provides tax-free treatment to both the corporation and the shareholders, so no tax is paid even though there has been a readjustment of the shareholders' investment.

The proposal applies only to non-pro-rata distributions and does not change the present law active business requirement for pro-rata tax-free corporate divisions in which each existing shareholder of the parent receives an interest in each of the resulting separate corporations that is

the same proportionate interest as the interest held in the parent corporation. Consideration should be given to whether such a disparity in treatment could result in pro-rata transactions structured to meet the old law requirements, followed by additional steps to achieve a result similar to the current cash-rich stock redemption transactions. In general, it would appear that any outright sales of stock for cash among shareholders, or other subsequent stock repurchases by the corporation following a pro-rata spin off, would either be taxable as an outright cash sale or would again be subject to the non-pro-rata rules of the proposal if structured as a corporate division. However, general anti-abuse rules might be desirable to prevent the use of partnerships or other arrangements to restructure the benefits and burdens of stock ownership among the shareholders after a pro-rata distribution. At the same time, consideration should be given to whether there may be situations where the definition of "non-pro rata" requires clarification, such as cases involving distributions with respect to different classes of stock, or cases where some small shareholders might be able to receive cash in lieu of stock.

Applying the new "active business" test only to non-pro-rata distributions might still permit some pro-rata transactions to occur that largely isolate cash or investment assets in one entity and risky business assets in the other, thus significantly changing the nature of the shareholders' holdings after the transaction. The limited application of the proposal does include the specific type of transaction that has attracted recent press attention as the "cash rich" redemption type division. Arguably, however, applying the new rule to all tax-free corporate divisions could provide greater consistency. Separating corporate assets to enable shareholders to have an interest in at least one corporation with a large proportion of cash or non-business investment assets could be considered contrary to the purpose of section 355 because such a transaction may effect a change in the shareholders' investment more similar to the distribution of a dividend than to a restructuring of business holdings.[341]

If the proposal were adopted, consideration might also be given to expanding the manner of its application so that the 50-percent active trade or business test would apply to each of the distributing and distributed corporation affiliated groups immediately after the transaction, rather than solely on a corporation by corporation basis. This could provide some additional structural flexibility to situations involving holding companies in a chain of entities and could reduce the complexity and possible difficulty of meeting the new 50-percent standard on the basis only of the parent distributing or distributed corporation.[342]

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[341] Tax free treatment under section 355 does not apply to a transaction that is used principally as a "device" for the distribution of earnings and profits. Sec. 355(a)(1)(B). The statute does not contain any absolute percentage threshold of nonbusiness assets that is forbidden under this test. It could be undesirable and possibly suggestive of a more liberal rule in pro-rata cases to establish a specific threshold for non-pro-rata transactions while allowing a continuing unspecified threshold in the pro-rata situation.

[342] A similar proposal addressing the group to which the present law active business test is applied was contained in the Joint Tax Committee Staff Simplification recommendations. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue*

Prior Action

No prior action.

Code of 1986 (JCS-3-01), April 2001, Vol. II at 251-252. Such a proposal was also contained in section 304 of the Senate amendment to H.R. 4250 (but was not adopted in the American Jobs Creation Act of 2004, which was the final enacted version of that legislation). See H.R. Rep. 108-755, 108th Cong. (2004) at 361-362.

C. Impose Penalties on Charities that Fail to Enforce Conservation Easements

Present Law

Section 170(h) provides special rules that apply to charitable contributions of qualified conservation contributions, which include conservation easements and façade easements. Qualified conservation contributions are not subject to the "partial interest" rule, which generally denies deductions for charitable contributions of partial interests in property. Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[343] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[344] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[345]

Description of Proposal

The Administration's proposal imposes "significant" penalties on any charity that removes or fails to enforce a conservation restriction for which a charitable contribution deduction was claimed, or transfers such an easement without ensuring that the conservation purposes will be protected in perpetuity. The amount of the penalty is determined based on the

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[343] Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)). Priv. Ltr. Rul. 8626029 (March 25, 1986).

[344] Treas. Reg. sec. 1.170A-14(e)(2).

[345] *Id*.

value of the conservation restriction shown on the appraisal summary provided to the charity by the donor.

Under the proposal, the Secretary is authorized to waive the penalty in certain cases, such as if it is established to the satisfaction of the Secretary that, due to an unexpected change in the conditions surrounding the real property, retention of the restriction is impossible or impractical, the charity receives an amount that reflects the fair market value of the easement, and the proceeds are used by the charity in furtherance of conservation purposes. The Secretary also is authorized to require such additional reporting as may be necessary or appropriate to ensure that the conservation purposes are protected in perpetuity.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

The proposal addresses the concern that charitable contributions of conservation restrictions, which are required to be in perpetuity, are being removed, or are being transferred without securing the conservation purpose. The proposal's solution to the problem is to impose penalties on the charity in such cases.

The intended scope of the proposal is not clear. The proposal applies to "removals," which some might argue includes significant modifications to conservation restrictions. A fair reading of the proposal would impose taxes in a case where a conservation restriction that prohibits development on 100 acres of property is modified after the contribution to prohibit development on only 50 of the acres. Although the conservation restriction is not removed in its entirety, a portion of the restriction is removed, constituting a "removal" for purposes of the proposal. Some might argue, however, that if modifications to conservation restrictions are penalized, certain non significant modifications, such as for mistake or clarity, or de minimus modifications, should not be penalized, and that determining whether a modification is significant introduces administrative complexity. On the other hand, some might argue that any such complexity could be overcome and that a proposal that is directed to enforcing the perpetuity requirement and that does not address significant modifications to property restrictions is not sufficient.

The suggested penalty of the proposal is "based on the value of the conservation restriction shown on the appraisal summary provided to the charity by the donor." The amount of the penalty is not clear. Under this standard, the penalty could be any percentage of such value. Some might argue that the penalty should recapture the tax benefit to the donor, and thus should equal the value of the conservation restriction that is removed or transferred times the highest applicable tax rate of the donor at the time of the contribution, plus interest. Others might argue that the penalty should equal such amount, plus an additional amount to penalize the charity for removing or transferring the easement. In either case, knowing the highest applicable tax rate of the donor may be difficult; thus in the alternative, a rate could be established by law. In addition, arguably the penalty also should take into account the present value of the restriction. For example, the removal or transfer of the restriction could occur many years after

the donation and in such a case, a penalty based on the value of the restriction at the time of the donation would not recover the tax benefit unless the present value is taken into account.

If the proposal applies to modifications of restrictions, however, a penalty based on recapture of the tax benefit presents additional complexity, in that a before and after appraisal would be required to determine the effect of the modification on the value of the property. For modifications, a better approach might be to impose as a penalty an established percentage (perhaps using the same percentage established for removals and transfers) times the value of the restriction (taking into account present value). Although such a penalty would recover more than the tax benefit, the excess above such benefit could be viewed as the additional penalty amount, mentioned above, that is imposed on the charity for permitting the modification. Alternatively, some might argue that the penalty need not recover the tax benefit, but should just be sufficiently high to deter the donee organization from removing the restriction.

The proposal provides the Secretary the authority to require additional reporting to ensure that conservation purposes are protected in perpetuity. Some might argue that such authority should specifically require a notification mechanism whereby a charity is required to inform the Secretary of modifications, removals, or transfers of conservation restrictions. Some might argue that notification is an important element of enforcement of the perpetuity requirement, and if made publicly available, would inform interested members of the public. Others might argue that a mere notification requirement would not accomplish much because charities that are subject to the penalty would not have an incentive honestly to notify the Secretary in any event.

The proposal applies not only to removals and transfers of conservation restrictions, but also to "failures to enforce" a conservation restriction. It is not clear what will constitute a failure for this purpose. A penalty could be triggered, for example, if a landowner violates the terms of a conservation restriction, and (i) the charity was aware of such violation before it occurred, (ii) the charity should have been aware of such violation, or (iii) the charity failed to take remedial measures after learning of such violation. In addition, in the case of a failure to enforce, the amount of the penalty is not clear. Arguably, as is the case with modifications of restrictions, if the violation is only with respect to certain terms of a restriction, calculating recovery of the tax benefit is complex. In addition, some would argue that any penalty for failure to enforce a conservation restriction also should be accompanied by a means of requiring that charities show the Secretary as part of their annual information return filings that sufficient amounts have been set aside for enforcement of conservation restrictions and that the charity has in place a program regularly to monitor property restrictions.

The proposal imposes penalties on charities and not on other qualified organizations that are eligible to accept qualified conservation contributions, such as governmental entities. Some would argue that a penalty also should be imposed on such entities, irrespective of their governmental status.

Prior Action

No prior action.

D. Eliminate the Special Exclusion from Unrelated Business Taxable Income ("UBIT") for Gain or Loss on Sale or Exchange of Certain Brownfield Properties

Present Law

In general

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes. Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include: (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption; (2) obligations to pay certain types of annuities; (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons; or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

Exclusion for sale, exchange, or other disposition of brownfield property

Present law provides an exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property by an eligible taxpayer. The exclusion from unrelated business taxable income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In addition, there is an exception from the debt-financed property rules for such properties.

In order to qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated

site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.[346]

Qualifying brownfield properties

The exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA). The taxpayer's request for certification must include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the property's presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield property in an amount that exceeds the greater of: (a) $550,000; or (b) 12 percent of the fair market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property

[346] A person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.[347]

Qualified sale, exchange, or other disposition

A sale, exchange, or other disposition of a qualifying brownfield property shall be considered as qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a "remediation certification") from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer's remediation actions, such property would not be treated as a qualifying brownfield property in the hands of the transferee. A taxpayer's request for a remediation certification shall be made no later than the date of the transfer and shall include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;[348] (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical improvements required to remediate the property, is either complete or substantially complete, and if substantially complete,[349] sufficient monitoring, funding, institutional controls, and

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[347] In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

[348] For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

[349] For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

financial assurances have been put in place to ensure the complete remediation of the site in accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of the provision)) was completed before the date of such request. Public notice shall include, at a minimum, publication in a major local newspaper of general circulation.

A copy of each of the requests for certification that the property was a brownfield site, and that it would no longer be a qualifying brownfield property in the hands of the transferee, shall be included in the tax return of the eligible taxpayer (and, where applicable, of the qualifying partnership) for the taxable year during which the transfer occurs.

Eligible remediation expenditures

Eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,[350] or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample, study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property, or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional liability coverage, or similar types of coverage;[351] (3) any amount paid or incurred to the extent

[350] Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

[351] For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage under policies referred to as owner-controlled insurance. Owner/operator liability coverage is coverage for those parties that own the site or conduct business or engage in cleanup

such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the proposal.[352]

Qualified gain or loss

In general, the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property is excluded from unrelated business taxable income. Income, gain, or loss from other transfers is not excluded.[353] The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. The exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.[354]

Special rules for qualifying partnerships

In general

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the exclusion applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the

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operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

[352] The Secretary of the Treasury is authorized to issue guidance regarding the treatment of government-provided funds for purposes of determining eligible remediation expenditures.

[353] For example, rent income from leasing the property does not qualify under the proposal.

[354] Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

disposition of the property.[355] A qualifying partnership is a partnership that (1) has a partnership agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property; (2) satisfies the requirements of the proposal if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.[356]

The Secretary is required to prescribe such regulations as are necessary to prevent abuse of the requirements of the provision, including abuse through the use of special allocations of gains or losses, or changes in ownership of partnership interests held by eligible taxpayers.

Certifications and multiple property elections

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying brownfield properties, however, may elect to make the eligible remediation expenditure determinations on a multiple-property basis. In the case of such an election, the taxpayer

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[355] The exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest. Such transactions continue to be governed by present-law.

[356] A tax-exempt partner is subject to tax on gain previously excluded by the partner (plus interest) if a property subsequently becomes ineligible for exclusion under the qualifying partnership's multiple-property election.

satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) $550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.[357]

An acquiring taxpayer makes a multiple-property election with its timely filed tax return (including extensions) for the first taxable year for which it intends to have the election apply. A timely filed election is effective as of the first day of the taxable year of the return in which the election is included or a later day in such taxable year selected by the taxpayer. An election remains effective until the earliest of a date selected by the taxpayer, the date which is eight years after the effective date of the election, the effective date of a revocation of the election, or, in the case of a partnership, the date of the termination of the partnership.

A taxpayer may revoke a multiple-property election by filing a statement of revocation with a timely filed tax return (including extensions). A revocation is effective as of the first day of the taxable year of the return in which the revocation is included or a later day in such taxable year selected by the eligible taxpayer or qualifying partnership. Once a taxpayer revokes the election, the taxpayer is ineligible to make another multiple-property election with respect to any qualifying brownfield property subject to the revoked election.[358]

Debt-financed property

Debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other disposition of which is excluded by reason of the provisions of the proposal that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the provision is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

Termination date

The Code provides for a termination date of December 31, 2009, by applying to gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible

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[357] If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

[358] A taxpayer is subject to tax on gain previously excluded (plus interest) in the event a site subsequently becomes ineligible for gain exclusion under the multiple-property election.

taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009. Property acquired during the five-year acquisition period need not be disposed of by the termination date in order to qualify for the exclusion. For purposes of the multiple property election, gain or loss on property acquired after December 31, 2009, is not eligible for the exclusion from unrelated business taxable income, although properties acquired after the termination date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

Description of Proposal

The proposal eliminates the special exclusion from unrelated business income and the debt-financed property rules.

Effective date.–The proposal is retroactive to January 1, 2005.

Analysis

The proposal repeals the recently enacted exclusion for gains from the disposition of remediated brownfield property from unrelated business income tax rules, citing administrative and policy concerns.

Administrative concerns

The proposal states that the exclusion adds significant new complexity to the Code and would be difficult to administer. By any measure, the exclusion is complicated; and the exclusion's complexity presents several administrative challenges. In general, although the policy of the proposal is simple -- exempt entities should not be deterred by unrelated business income tax rules from investing in contaminated properties for the purposes of remediating the property prior to sale -- the exclusion mechanically is complex in order to prevent abuse and because of the difficult and technical nature of the problem being addressed. The question raised by the proposal essentially is whether such requisite complexity makes the exclusion too difficult to administer and thus, ineffective policy at best, and a potentially abusive provision at worst.

Although the proposal does not cite specific administrative concerns, there are several aspects of the proposal that might be at issue. For example, the exclusion requires that remediation expenses on brownfield property be incurred in an amount that exceeds the greater of $550,000 or 12 percent of the fair market value of the property determined at the time the property is acquired and as if the property were not contaminated. Such a determination of value may be difficult for the IRS to enforce, with the effect of making the $550,000 component of the test a ceiling and not a floor for required remediation expenses. Also, the remediation expense test may be applied on a property-by-property basis or, by an election, on a multiple property basis. Under the multiple property test, in general, all the remediation expenses and noncontaminated values of properties acquired within an eight-year period are taken into account. Because the election period potentially is eight years, and tens or hundreds of properties could be sold during such time, it could be difficult for the IRS to determine whether bona fide remediation expenses were made with respect to each property or what the respective noncontaminated values of the properties are.

Another area of concern for the IRS might be that the exclusion is not extended to certain persons that are potentially liable under CERCLA with respect to the acquired property. This may require the IRS to make determinations under environmental laws, which may prove difficult. The exclusion also requires the taxpayer to provide the IRS with copies of certifications that the property was, prior to remediation, a qualified brownfield property and that, at the time of disposition, the property no longer is a brownfield property. Although the IRS is not involved in the certification process (the EPA and State agencies generally are responsible for issuing such certifications), the IRS must maintain the certifications, perhaps for many years, and examine them in order to test the validity of the exclusion.

A significant administrative concern also might be determining whether an expense is an eligible remediation expense, which is a matter of critical importance to the policy supporting the exclusion. The definition of an eligible expense is detailed and descriptive, but not precise. Given the complexity of the definition, it likely will be resource intensive and difficult for the IRS to challenge a taxpayer's accounting of remediation expenses.

Another complicating factor is that qualified property may have gain that is excludable because of the special rules and gain that is not excludable, such as rental income from the property. The exclusion also does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including certain section 198 expenses. Although these rules are clear, it may nonetheless be difficult for the IRS to administer in the context of a provision that excludes some kinds of gain and taxes others.

The exclusion also has special rules for partnerships (which likely is the vehicle that will often be utilized for purposes of the exclusion), which require, among other things that the Secretary issue regulations to prevent abuse, including abuse through the use of special allocations of gains or losses or changes in ownership of partnership interests held by eligible taxpayers. The exclusion also contains a related-party rule and a recapture provision, which contribute to the administrative complexity of the exclusion.

By virtue of the proposal to repeal the exclusion, the President has concluded, albeit without identifying specific areas of concern, that the administrative complexity engendered by the exclusion outweighs any policy benefits that may result from the exclusion. Some might argue that the exclusion should be given time to see whether it proves as complicated to administer as it appears. Others might agree that the self-evident complexity of the conclusion warrants repeal.

Policy concerns

The President expresses the concern that the exclusion is not sufficiently targeted because it excludes from unrelated business income all of the gain from the disposition of qualified property, irrespective of whether the gain is attributable to remediation by the taxpayer. Under this view, arguably the exclusion should be provided only to gain that results from remediation activity, and permitting the exclusion of gain resulting from nonremediation-related property development provides an unwarranted windfall to the taxpayer. Some might argue that the proposal is broad by design in order to encourage the development of contaminated sites, because without the benefit of exclusion for all of a property's gain, taxpayers will not have a

sufficient incentive to acquire and remediate contaminated property. Nevertheless, the multiple property election of the proposal may permit taxpayers to acquire a brownfield site where little remediation is required, significantly develop the property, and sell the property without paying tax on the gain so long as the average expenses over all the properties meet the requirements of the multiple property election. Even so, some might argue that it is too soon to determine whether the exclusion is overbroad, as the exclusion has not yet been utilized.

Prior Action

No prior action.

E. Apply an Excise Tax to Amounts Received Under Certain Life Insurance Contracts

Present Law and Background

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[359] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[360]

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 to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[361]

Transfers for value

Although the general rule is that gross income does not include amounts received under a life insurance contract paid by reason of the death of the insured, a limitation on this exclusion is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.[362]

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[359] Sec. 101(a).

[360] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[361] Sec. 72(e). In the case of a modified endowment contract, however, in general, 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 (secs. 72(e) and (v)). 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 seven annual level premiums (sec. 7702A).

[362] Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

Tax treatment of charitable organizations and donors

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.[363] Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.[364]

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.[365]

State-law insurable interest rules

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. Insurable interest requirements generally reflect a social policy against gambling on the life of an individual for profit, and some insurable interest laws have incorporated a notion that the owner of the life insurance contract should have an interest in the continued life of the insured person.[366]

State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,[367] or, in other States, in the life of any individual who consents (whether or not the individual is a

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[363] Section 501(c)(3).

[364] Section 115.

[365] Section 170.

[366] See, e.g., S. Leimberg and A. Gibbons, *COLI, BOLI, TOLI and Insurable Interests*, 28 Est. Plan. 333 (July 2001) (describing the development of insurable interest rules under 18th-century English law). See also testimony of J.J. McNabb before the Senate Finance Committee, "Hearings on Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities," Committee Print, 108th Cong., 2d Sess., June 22, 2004.

[367] See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . .).

donor).[368] Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.[369]

Transactions involving charities and non-charities acquiring life insurance

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both charities and private investors have an interest in the contract.[370] The charity has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts. Both the private investors and the charity have an interest in the life insurance contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the life insurance contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the life insurance while the life insurance is in force or as the insured individuals die.

Description of Proposal

The proposal imposes an excise tax on any payment received by a person under a life insurance contract (whether a death benefit, dividend, withdrawal, loan, or surrender payment), if both a charity and a non-charity have ever had a direct or indirect interest in the contract. For this purpose, an indirect interest includes an interest in an entity that holds an interest in the life insurance contract. The excise tax is imposed on such a payment received by any person, whether a charity or a non-charity, and is imposed without regard to the income tax treatment of the payment. The rate of the excise tax under the proposal is 25 percent.

No Federal income tax deduction is permitted for the excise tax payable under the proposal. The amount of the excise tax payable under the proposal is not included in the investment in the contract.

Exceptions to the application of the excise tax apply under the proposal. The excise tax does not apply if each non-charity with a direct or indirect interest in the life insurance contract has an insurable interest in the insured independent of the charity's interest. The excise tax does not apply if the non-charity's sole interest in the life insurance contract is as a named beneficiary. Treasury regulatory authority is provided under the proposal to provide exceptions to the

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[368] See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40-512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

[369] Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

[370] Davis, Wendy, "Death-Pool Donations," Trusts and Estates, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," Wall St. J., Feb. 8, 2005, A-10.

application of the excise tax based on specified factors including (1) whether the transaction is at arms' length, (2) the relative economic benefits to the charity as compared to the non-charity participants in the arrangement, and (3) the likelihood of abuse. Treasury regulatory authority is also provided to prevent avoidance of the provision, including through the use of intermediaries.

Effective date.–The proposal is effective for amounts received under a life insurance contract entered into after February 7, 2005.

Analysis

The proposal reflects a concern that arrangements in which both charities and private investors have an interest in life insurance contracts may accord unintended Federal tax benefits to the private investors. The charity may effectively be renting out its insurable interest in individuals in whom the private investors have no insurable interest, making available a tax-favored life insurance investment that would not otherwise be available. Alternatively, the arrangement could be viewed as an inappropriate sharing of the charity's tax-exempt status with private persons.

The generous scope of a charity's insurable interest in the lives of a broad class of individuals under many States' laws facilitates private investment in life insurance together with a charity in situations in which the private investment without the charity's involvement would violate insurable interest rules. Although insurable interest rules are a matter of State, not Federal, law, an indirect consequence of the broad insurable interest rules for charities is a broadened availability of Federal-tax-favored investments in life insurance that may be inconsistent with the rationale for the favorable tax rules for life insurance. The rationale for favorable tax treatment of life insurance has been described as encouraging breadwinners to provide for their dependents financially in the event of the breadwinners' untimely death. Arguably, this rationale cannot support the growth of pools of insured individuals who have no relation to the private investors funding the purchase of life insurance contracts on those individuals. The use of pools of insured individuals may also violate the original purpose of insurable interest laws to prevent dead pools and prohibit betting on individuals' deaths for profit.

Alternatively, the use of a charity's insurable interest under State law could be viewed as an inappropriate sharing of the charity's tax-exempt status with private persons. The renting out of State-law insurable interests that are based on the entity's status as a charity for Federal tax purposes is tantamount to using the charity's favored Federal tax status for private gain, it may be argued. This type of arrangement is inconsistent with the Federal tax law requirement that a charity be operated exclusively for charitable purposes. An excise tax on such transactions that is applicable both to the charity and to the investors, as provided under the proposal, can be seen as an intermediate sanction, short of revocation of the charity's tax-exempt status.

Nevertheless, charities that are short of cash may find that the joint investment in life insurance with cash-rich private investors generates needed revenue and funds the continuation of charitable activities. Even though the charities share the death benefits or other proceeds under the life insurance contracts with private investors, the arrangement may provide a source of cash to a charity that might not otherwise be available. It could be argued that the social

benefit of increasing the flow of funds to charities outweighs both the social detriment of permitting investments in what some characterize as dead pools and the tax policy concern of spreading the tax benefit of life insurance beyond its intended function.

Some arrangements in which both charities and non-charities have an interest in the same life insurance contracts may not involve shifting the tax-favored treatment of life insurance from charities to private investors. For example, some of these transactions are conducted through partnerships, from which payments to the private investors take the form of taxable guaranteed payments or other taxable payments. In these transactions, the purchase of life insurance on individuals in which the charity has an insurable interest is funded by annuity contracts purchased with capital contributed by the private investors. In such transactions, arbitrage is achieved not by relying on tax-free payments to the private investors, but rather, by relying on pricing differentials arising from differing mortality assumptions under the annuity contracts and the life insurance contracts. Nevertheless, in these arrangements, the charity may still be characterized as renting out an insurable interest in an individual in whom the private investor would not have an insurable interest, absent the charity's participation in the transaction.

It could be argued that the present-law transfer-for-value rules should serve to prevent the shifting of tax benefits from a charity with an insurable interest in insured individuals to private investors. However, in the transactions, the acquisition of the contract may be structured in such a way that there is no transfer of the life insurance contract subsequent to its original purchase. It could, however, be argued that application of general principles of tax law such as the sham transaction doctrine, economic substance, or form over substance, should cause the transaction to be characterized as a transfer for value.

Prior Action

No prior action.

F. Limit Related-Party Interest Deductions

Present Law

A U.S. corporation with a foreign parent may reduce the U.S. tax on its U.S.-source income through the payment of deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned U.S. corporations may use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.[371]

Generally, present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) generally disallows a deduction for so called "disqualified interest" paid or accrued by a corporation in a taxable year, if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor"); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Under section 424 of the American Jobs Creation Act of 2004 ("AJCA"), the Treasury Secretary is required to submit to the Congress a report examining the effectiveness of the earnings stripping provisions of present law. This report is due no later than June 30, 2005.

Description of Proposal

The proposal eliminates the safe harbor and the excess limitation carryforward of present law. In addition, the proposal reduces the present-law threshold of 50 percent of adjusted taxable income to 25 percent with respect to interest on related-party debt. With respect to interest on guaranteed debt, the present-law threshold of 50 percent of adjusted taxable income is retained. The carryforward of disallowed interest is limited to 10 years.

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[371] For example, it appears that the U.S.-Barbados income tax treaty was often used to facilitate earnings stripping arrangements. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, *see* Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Barbados* (JCX-55-04), September 16, 2004, 12-20, 22.

The Treasury Department also indicates that the study required under AJCA is underway, and that the report of this study may include further recommendations in this area.

Effective date.–The proposal is effective on the date of first committee action.

Analysis

Recent inversion transactions led some to question the efficacy of the present-law earnings stripping rules.[372] In some cases, it appeared that the earnings stripping benefit achieved when a U.S. corporation paid deductible amounts to its new foreign parent or other foreign affiliates constituted the primary intended tax benefit of the inversion transaction, which should not have been the case if the earnings stripping rules had been functioning properly.[373] By eliminating the debt-equity safe harbor, reducing the adjusted taxable income threshold from 50 percent to 25 percent for interest on related-party debt, limiting the carryforward of disallowed interest to 10 years, and eliminating the carryforward of excess limitation, the proposal would significantly strengthen rules that have proven ineffective in preventing certain recent earnings stripping arrangements.

On the other hand, some may view the proposal as unnecessary and overbroad, arguing that there is no empirical evidence of a significant earnings stripping problem outside the context of inversion transactions. Under this view, the recently enacted anti-inversion rules of section 7874, combined with recent treaty developments (mainly the 2004 protocol to the U.S.-Barbados income tax treaty), should constitute a sufficient response to any earnings stripping problem that might have existed. Proponents of the proposal may respond that, although recent legislative and treaty developments have removed some significant opportunities for earnings stripping, other opportunities may remain, and thus erosion of the U.S. tax base will continue until the statutory earnings stripping rules themselves are strengthened.

Some may take the view that the proposal does not go far enough in curtailing earnings stripping. While the proposal would have the effect of further limiting the ability of taxpayers to erode the U.S. tax base through earnings stripping transactions involving interest, the proposal does not address earnings stripping transactions involving the payment of deductible amounts

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[372] See, e.g., Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003, 104 ("Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications,* May 17, 2002, Part VII.A ("Treasury study") ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited").

[373] See, e.g., Treasury study, Part VII.A; Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, 3-4.

other than interest (e.g., rents, royalties, and service fees), or the payment of deductible amounts by taxpayers other than corporations. These transactions also may erode the U.S. tax base, and thus it may be argued that a more comprehensive response to earnings stripping is needed. Indeed, as opportunities for stripping earnings in the form of interest are reduced, taxpayers may find it increasingly attractive to strip earnings through other means. Proponents of the proposal may respond that earnings stripping is much more readily achieved through the use of debt than through other means, and that there is insufficient evidence to suggest that these other forms of stripping warrant a new legislative response.

Finally, some may argue that further action in this area should be deferred until the Treasury Department completes its study and submits its report to the Congress. It is hoped that this report will provide new data and analysis that will further inform the discussion in this area.

Prior Action

H.R. 2896, the "American Jobs Creation Act of 2003," as passed by the House Committee on Ways and Means in 2003, contained a similar proposal. No such proposal was included in AJCA as enacted in 2004.

The same proposal was included in the President's fiscal year 2005 budget proposal. The President's fiscal year 2004 budget proposal contained a different earnings stripping proposal that changed present law by modifying the safe harbor provision, reducing the adjusted taxable income threshold, adding a new disallowance provision based on a comparison of domestic to worldwide indebtedness, and limiting carryovers.

G. Modify Certain Tax Rules for Qualified Tuition Programs

Present Law

Overview

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[374] A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program").[375] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program").[376] Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance.[377] Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.[378]

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account

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[374] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

[375] Sec. 529(b)(1)(A).

[376] Sec. 529(b)(1)(A).

[377] Sec. 529(e)(3)(A).

[378] Sec. 529(e)(3)(B).

owner") whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.[379]

Under present law, section 529 does not establish eligibility requirements for designated beneficiaries. Accordingly, a beneficiary of any age may be named as a designated beneficiary. Special considerations generally apply to accounts that are funded by amounts subject to Uniform Gifts to Minors Act ("UGMA") or Uniform Transfers to Minors Act ("UTMA") laws.

Section 529 does not provide for any quantitative limits on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account, other than to require that the program provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.[380] Many qualified tuition programs impose limits on the maximum amount of contributions that may be made, or account balances that may accrue, for the benefit of a designated beneficiary under that program.[381]

Under present law, contributions to a qualified tuition account must be made in cash.[382] A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to directly or indirectly direct the investment of any contributions (or earnings thereon),[383] and must provide separate accounting for each designated beneficiary.[384] A qualified

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[379] Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.

[380] Sec. 529(b)(6).

[381] For example, a qualified tuition program might provide that contributions to all accounts established for the benefit of a particular designated beneficiary under that program may not exceed a specified limit (e.g., $250,000), or that the maximum account balance for all accounts established for the benefit of a particular designated beneficiary under that program may not exceed a specified limit. In the case of prepaid tuition contracts, the limit might be expressed in terms of a maximum number of semesters.

[382] Sec. 529(b)(2).

[383] Sec. 529(b)(4).

[384] Sec. 529(b)(3).

tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.[385]

Special rules apply to coordinate qualified tuition programs with other education benefits, including Coverdell education savings accounts, the HOPE credit, and the lifetime learning credit.[386]

Income tax treatment

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax, although it is subject to the tax on unrelated business income.[387] Contributions to a qualified tuition account (or with respect to a prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education expenses, no portion of the distribution is subject to income tax.[388] If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax,[389] and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).[390] A change in the designated beneficiary of an account or prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.[391]

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[385] Sec. 529(b)(5).

[386] Sec. 529(c)(3)(B)(v) and (vi).

[387] Sec. 529(a). An interest in a qualified tuition account is not treated as debt for purposes of the debt-financed property rules. Sec. 529(e)(4).

[388] Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

[389] Sec. 529(c)(3)(A) and (B)(ii).

[390] Sec. 529(c)(6).

[391] Sec. 529(c)(3)(C)(ii). For this purpose, "member of family" means, with respect to a designated beneficiary: (1) the spouse of such beneficiary; (2) an individual who bears a relationship to such beneficiary which is described in paragraphs (1) through (8) of section 152(a) (i.e., with respect to the beneficiary, a son, daughter, or a descendant of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law), or the spouse of any such individual; and (3) the first cousin of such beneficiary. Sec. 529(e)(2).

Gift and generation-skipping transfer (GST) tax treatment

A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary.[392] Such contributions qualify for the per-donee annual gift tax exclusion ($11,000 for 2005), and, to the extent of such exclusions, also are exempt from the generation-skipping transfer (GST) tax. A contributor may contribute in a single year up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.[393]

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax.[394] Those taxes may apply, however, to a change of designated beneficiary if the new designated beneficiary is in a generation below that of the old beneficiary or if the new beneficiary is not a member of the family of the old beneficiary.[395]

Estate tax treatment

Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual.[396] Amounts distributed on account of the death of the designated beneficiary, however, are includible in the designated beneficiary's gross estate.[397] If the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.[398]

Powers of appointment

Special income tax and transfer tax rules apply to instances where a person holds a power of appointment or certain other powers with respect to property. In general, a power of appointment includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law

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[392] Sec. 529(c)(2)(A).

[393] Sec. 529(c)(2)(B).

[394] Sec. 529(c)(5)(A).

[395] Sec. 529(c)(5)(B).

[396] Sec. 529(c)(4)(A).

[397] Sec. 529(c)(4)(B).

[398] Sec. 529(c)(4)(C).

connotations, and may include, for example, the power to consume or appropriate the property, or to affect the beneficial enjoyment of principal or income through a power to revoke, alter or amend the terms of the instrument (such as changing the designated beneficiary of property).[399] The nature of the power held by a person affects whether the holder of the power is taxed on the income on the property, and whether the property subject to the power is treated as includible within the estate of the holder of the power or is subject to gift tax.[400]

Description of Proposal

Overview

The proposal modifies certain income tax, gift tax, generation-skipping transfer tax, and estate tax rules with respect to changes in designated beneficiaries of qualified tuition accounts. The proposal modifies the present-law provisions regarding the imposition of the 10-percent additional tax, and imposes new excise taxes on amounts that are used other than for qualified higher education expenses.

Changes in designated beneficiaries

The proposal modifies present law by providing that a change in the designated beneficiary of a qualified tuition account does not cause the imposition of gift tax or GST tax, regardless of whether the new designated beneficiary is in a generation below that of the former designated beneficiary. The proposal also provides that gift tax and GST tax is not imposed even if the new designated beneficiary is not a member of the family of the old beneficiary. The proposal modifies the income tax treatment of a change in a designated beneficiary to provide that a change of designated beneficiary to a new eligible designated beneficiary who is not a member of the family of the old beneficiary is not treated as a distribution for income tax purposes.[401]

The proposal provides that upon the death of a designated beneficiary, the account is to be distributed to the estate of the designated beneficiary, thereby triggering potential income tax and estate tax consequences, unless a new eligible designated beneficiary is named in a timely manner or the contributor withdraws the funds from the account. The designated beneficiary's gross estate would include only amounts (if any) paid to the estate or pursuant to the designated beneficiary's general power of appointment.

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[399] Sec. 20.2041-1(b)(1). See also secs. 674, 2041, and 2514.

[400] Powers of appointment are often classified as "general powers of appointment" or as "limited" or "special" powers of appointment.

[401] This change is proposed in order to be consistent with the objective of imposing no taxes on a change of designated beneficiary so long as the new beneficiary is an eligible designated beneficiary and the funds are not used for nonqualified purposes.

Rules applicable to contributors; account administrators

Under the proposal, each section 529 account may have only one contributor. A section 529 program is permitted to accept contributions to a section 529 account only from the account contributor (or the contributor's irrevocable trust) and, to the extent provided by the Secretary, from other persons in a de minimis amount.

As under present law, the contributor to a section 529 account is permitted to withdraw funds from the account during the contributor's lifetime, subject to income tax on the income portion of the withdrawal. An additional tax applies to the income portion of a withdrawal unless the withdrawal is due to the designated beneficiary's death, disability, receipt of a scholarship or attendance at a U.S. military academy. Under the proposal, the amount of the additional tax is generally 10 percent and is increased to 20 percent if the withdrawal occurs more than 20 years after the account was originally created.

Under the proposal, the contributor may name another person to administer the account (the "account administrator"). The account administrator would have no beneficial interest in the account. The account administrator would be permitted to change the designated beneficiary "from time to time". Neither the account administrator nor the administrator's spouse could be or become a designated beneficiary, except as provided by the Secretary.

Imposition of excise tax on nonqualifying distributions

The proposal retains the present-law income tax treatment of distributions from a qualified tuition account that are used for qualified higher education expenses. Such distributions are not subject to income tax, regardless of the distributee's identity. As under present law, distributions used for purposes other than qualified higher education expenses are subject to income tax on the earnings portion of the distribution. Further, the proposal imposes additional excise taxes with respect to distributions that are used other than for qualified higher education expenses if the distribution is made to someone other than the contributor or the initial designated beneficiary. Nonqualified distributions in excess of $50,000 but less than or equal to $150,000 (computed on a cumulative basis for each designated beneficiary, including for this purpose the entire amount of the distribution, not just earnings) are subject to a new excise tax imposed at the rate of 35 percent. Nonqualified distributions in excess of $150,000 (computed on a cumulative basis for each designated beneficiary, including for this purpose the entire amount of the distribution, not just earnings) are subject to an excise tax imposed at the rate of 50 percent. The excise tax is payable from the account and is required to be withheld by the program administrator.

Changes in reporting requirements

The proposal modifies the reporting requirements applicable to qualified tuition accounts. For example, new reporting requirements would be established to facilitate the administration of excise tax withholding by administrators. Such requirements might include certifications provided by designated beneficiaries to administrators of qualified tuition programs, so that administrators may withhold appropriate amounts of excise taxes with respect to distributions used other than for qualified higher education expenses.

Grant of regulatory authority to Treasury

The proposal grants the Secretary of the Treasury broad regulatory authority to ensure that qualified tuition accounts are used in a manner consistent with Congressional intent.

Effective dates

The proposal generally is effective for qualified tuition accounts (including savings accounts and prepaid tuition contracts) established after the date of enactment of the proposal, including prepaid tuition contracts if additional prepaid tuition benefits are purchased on or after the date of enactment of the proposal. The proposal does not apply to qualified tuition savings accounts that are in existence on the date of enactment unless an election is made to be covered by the new rules. No additional contributions to savings accounts in existence on the date of enactment of the proposal would be permitted without such election.[402]

The modified reporting requirements apply after the date of enactment of the proposal to all qualified tuition accounts (including savings accounts and prepaid tuition contracts).

Analysis

Overview

The President's budget proposal addresses certain transfer tax anomalies with regard to changes in designated beneficiaries by providing that a change of beneficiary to another eligible beneficiary does not constitute a transfer for gift or generation-skipping transfer tax purposes or a distribution for income tax purposes. In addition, by requiring that no person other than a designated beneficiary possess any beneficial interest in a qualified tuition account, the proposal attempts to more closely align the gift tax treatment of contributions to qualified tuition accounts (i.e., a completed gift of a present interest to the designated beneficiary) with the treatment of contributions under generally applicable transfer tax principles. The proposal addresses potential abuses of qualified tuition accounts by establishing eligibility rules for designated beneficiaries, and imposing an excise tax on distributions that are not used for qualified higher education expenses and increasing the additional tax on nonqualified withdrawals by the contributor more than 20 years after the creation of the account.

Section 529 transfer tax treatment and generally applicable transfer tax provisions

Overview

Certain aspects of present-law section 529 depart from otherwise generally applicable transfer tax principles. For example, present law treats a contribution to a qualified tuition

[402] In cases where an existing account or contract is subject to the new rules, the entire account or contract is subject to the new rules, not just that portion of the account or contract that relates to contributions made, or prepaid benefits acquired, after the date of enactment.

account as a completed gift of a present interest to the designated beneficiary,[403] even though in most instances, the designated beneficiary possesses no rights to control the qualified tuition account or withdraw funds, and such control (including the right to change beneficiaries or to withdraw funds, including for the benefit of someone other than the designated beneficiary) is vested in the account owner. Absent section 529, such contributions generally would not be treated as completed gifts to the designated beneficiary under otherwise applicable transfer tax principles.[404] Further, present-law section 529 does not address the transfer tax consequences of a change of account owners of a qualified tuition account.[405]

Treatment of changes of designated beneficiaries

Under present-law section 529, a change of designated beneficiary to a beneficiary who is in a generation lower than the former beneficiary (or who is not a family member of the former beneficiary) constitutes a taxable gift, even though the new designated beneficiary would, under otherwise applicable transfer tax principles, be regarded as not receiving a completed gift. Further, present-law section 529 does not identify which party is responsible for payment of the transfer tax when it is imposed in such instances. Also, under present-law section 529, there is no express requirement that the multiple annual present interest exclusion is available only if there is a present intent to allow the designated beneficiary to receive the benefits of the qualified tuition program.

Present law also has different change-of-beneficiary rules for income tax and transfer tax purposes. A change of beneficiary to a person who is not a member of the same family as the old beneficiary is treated as a distribution for income tax purposes, regardless of whether the new beneficiary is in a lower generation than the former beneficiary. Under present law, a change of beneficiary to a person who is in a lower generation than the former beneficiary is treated as a transfer for transfer tax purposes, regardless of whether the new beneficiary is of the same family as the former beneficiary.

The proposal eliminates these disparities and provides that a change of beneficiary will not be treated as a distribution or transfer.

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[403] Sec. 529(c)(2).

[404] Under otherwise applicable transfer tax principles, the designated beneficiary's lack of control over the qualified tuition account generally would cause the beneficiary's interest in the account to be regarded as a future interest, and any completed gift of a present interest would be regarded as having been made from the contributor to the account owner (rather than to the designated beneficiary). In cases where the contributor and the account owner are the same person, no gift would take place under generally applicable transfer tax principles.

[405] A change of account owner might be regarded as a completed gift of a present interest from the old account owner to the new account owner, or as having no tax consequences because a completed gift had been made to the designated beneficiary.

Because the proposal expands the class of permissible successor designated beneficiaries without the imposition of any income or transfer taxes, individuals interested in establishing a qualified tuition account as a means to fund qualified higher education expenses for their children, relatives, or others, might view these changes as being a liberalization and simplification of existing law.

Potential abuses addressed by the proposal

The proposal attempts to discourage substantial multi-generational accumulations of qualified tuition account assets by imposing new excise taxes on distributions that are ultimately used other than for qualified higher education expenses. The proposed excise tax is imposed only if an actual distribution occurs and the distributed amounts are not used for qualified higher education expenses. The excise tax does not apply if a distribution is made to the estate of a deceased designated beneficiary, or to a designated beneficiary on account of the designated beneficiary's disability, receipt of a scholarship, or attendance at a military academy. Excise taxes on the entire amount of a distribution that exceeds certain cumulative thresholds, including on both the principal and earnings components, would be imposed. Such excise taxes are intended to serve as deterrents to using the funds other than for qualified higher education expenses. However, the excise taxes are not imposed unless an actual or deemed distribution occurs, and thus would not be imposed so long as the funds are maintained in a qualified tuition account that continues to be held for the benefit of an eligible designated beneficiary. The proposal does not impose a specific deadline by which time the funds must be used for education expenses or become subject to income, excise, and transfer taxes.

Some may argue that this proposal does not go far enough to deter (or in fact may create an opportunity to achieve) substantial multi-generational accumulations of qualified tuition account assets, and that a better approach would be to impose caps on the amounts that can be contributed to such accounts, or on the length of time that such assets can be held. Enforcing such caps, however, would impose significant administrative burdens on administrators, taxpayers, and the IRS. Others may argue that the present-law requirement that the account or contract provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary, combined with the maximum contribution or account balance limits established by many of the various qualified tuition programs, adequately address any concerns that such accounts might be used to improperly accumulate assets for purposes other than providing for qualified higher education expenses of the designated beneficiary. Others may counter that program-imposed limits are applied only on a per-State basis, and further, that the ability of an individual to establish accounts for an unlimited number of designated beneficiaries means there are no effective limits under present law.

Prior Action

A similar proposal was contained in the President's fiscal year 2005 budget proposal.

VI. TAX ADMINISTRATION PROVISIONS AND UNEMPLOYMENT INSURANCE

A. IRS Restructuring and Reform Act of 1998

1. Modify section 1203 of the IRS Restructuring and Reform Act of 1998

Present Law

Section 1203 of the IRS Restructuring and Reform Act of 1998 requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets; (2) providing a false statement under oath material to a matter involving a taxpayer; (3) with respect to a taxpayer, taxpayer representative, or other IRS employee, the violation of any right under the U.S. Constitution, or any civil right established under titles VI or VII of the Civil Rights Act of 1964, title IX of the Educational Amendments of 1972, the Age Discrimination in Employment Act of 1967, the Age Discrimination Act of 1975, sections 501 or 504 of the Rehabilitation Act of 1973 and title I of the Americans with Disabilities Act of 1990; (4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or a taxpayer representative; (5) assault or battery on a taxpayer or other IRS employee, but only if there is a criminal conviction or a final judgment by a court in a civil case, with respect to the assault or battery; (6) violations of the Internal Revenue Code, Treasury Regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating or harassing a taxpayer or other IRS employee; (7) willful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry; (8) willful failure to file any tax return required under the Code on or before the due date (including extensions) unless failure is due to reasonable cause; (9) willful understatement of Federal tax liability, unless such understatement is due to reasonable cause; and (10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.

Section 1203 also provides non-delegable authority to the Commissioner to determine that mitigating factors exist, that, in the Commissioner's sole discretion, mitigate against terminating the employee. The Commissioner, in his sole discretion, may establish a procedure to determine whether an individual should be referred for such a determination by the Commissioner.

Description of Proposal

The proposal removes the following from the list of violations requiring termination: (1) the late filing of refund returns; and (2) employee versus employee acts. The proposal also adds unauthorized inspection of returns and return information to the list of violations. Additionally, the proposal requires the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by section 1203 of the IRS Restructuring and Reform Act of 1998. The Commissioner retains the non-delegable authority to determine whether mitigating factors support a personnel action other than that specified in the guidelines for a covered violation.

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

Analysis

Policy issues

Late filing of refund returns

The proposal has the effect of treating IRS employees more like individuals employed by any other employer, with respect to late filing of refund returns. Late filing generally is not grounds for termination by most employers. In addition, late filing of refund return is generally not subject to penalty under the Code.[406] Proponents of the proposal relating to late filings may argue that late filings of refund return is not the type of serious conduct for which the severe penalties imposed by the IRS Restructuring and Reform Act should apply. Others may argue that IRS employees, as the enforcers of the country's tax laws, should be held to a higher standard and be required to timely file all income tax returns.

Employee vs. employee allegation

Advocates of removing employee versus employee conduct from the list of grounds for IRS employee termination may argue that allegations of willful conduct by IRS employees against other IRS employees can be addressed by existing administrative and statutory procedures. Other means, such as the Whistleblower Protection Act, negotiated grievance processes, and civil rights laws, exist to address employee complaints and appeals. Moreover, it is argued that under present-law rules, parallel investigative and adjudicative functions for addressing employee complaints and appeals are confusing to employees and burdensome for the IRS.

Proponents also believe that it is appropriate to remove employee versus employee conduct from the list of section 1203 violations because, unlike other section 1203 violations, such conduct does not violate taxpayer protections. On the other hand, opponents may point out that Congress believed it appropriate to include such conduct in the statutory list of grounds for IRS employee termination. They may argue that including employee versus employee conduct in the section 1203 violation list benefits tax administration. Another issue to consider is the extent to which the inclusion of employee versus employee conduct on the list of section 1203 violations deters inappropriate behavior (by reducing the likelihood of real employee versus employee actions) or increases inappropriate behavior (by increasing the number of allegations of inappropriate behavior against other employees for purposes of intimidation, harassment, or retribution).

Unauthorized inspection of returns

Advocates of the proposal argue that unauthorized inspection of tax returns and return information is a serious act of misconduct that should be included in the list of violations subject to termination, as unauthorized inspection is as serious as the other taxpayer rights protections

[406] The refund claim must be filed prior to the expiration of the applicable statute of limitations for the taxpayer to receive the refund.

covered by section 1203. Code section 7213A already makes the unauthorized inspection of returns and return information illegal, with violations punishable by fine, imprisonment, and discharge from employment. Even though unauthorized inspection is punishable under a separate law, it is argued that extending section 1203 coverage to unauthorized inspection will strengthen the IRS' power to discipline without the penalty being overturned.

On the other hand, opponents of this part of the proposal may point out that most violations of Code section 7213A are not prosecuted, but employees are subject to discipline based on administrative determination. The IRS policy has been to propose termination of employment in cases of unauthorized inspection, but in a number of recent cases, arbitrators and the Merit Systems Protection Board have overturned the IRS' determination to terminate employees for such violations.

Advocates may also argue that adding unauthorized inspection of returns to the list of section 1203 violations will prevent overturning of the IRS' determination of the level of appropriate employee punishment. Some might question whether it is appropriate to use an internal administrative process to achieve a result that the IRS states that it has been unable to achieve through judicial or external administrative processes. In addition, adding unauthorized inspection of returns to the list of section 1203 violations could add to the fear of IRS employees that they will be subject to unfounded allegations and lose their jobs as a result, which might deter fair enforcement of the tax laws.

The position taken by the IRS with respect to this part of the proposal can be criticized as inconsistent with its position on the employee versus employee allegations piece of the proposal. The IRS argues that employee versus employee conduct should be removed from the list of section 1203 violations because such conduct can be addressed by existing administrative and statutory procedures, while at the same time argues that unauthorized inspection of returns should be added to the list of violations even though it is punishable under a separate law. Some might view these positions as inconsistent.

While the proposal makes unauthorized inspection (which is a misdemeanor) a section 1203 violation, it does not make unauthorized disclosure (which is a felony under Code section 7213) a section 1203 violation. Arguably, more damage can be done by disclosing sensitive tax information to a third party than by looking at a return out of curiosity. Thus, the proposal can be criticized as lacking the proper focus.

Penalty guidelines

Some are concerned that the IRS' ability to administer the tax laws efficiently is hampered by a fear among employees that they will be subject to false allegations and possibly lose their jobs. Proponents of the proposal requiring the IRS to publish detailed guidelines argue that these guidelines are needed to provide notice to IRS employees of the most likely punishment that will result from specific violations. They believe that the certainty provided by specific guidelines would improve IRS employee morale and enhance the fundamental fairness of the statute.

Others argue that since Congress intended for the section 1203 violations to warrant termination, it is not appropriate to allow the IRS to determine a lesser level of punishment. Additionally, they argue that the claim that penalty guidelines are necessary is inconsistent with the proposal to remove from the list the two violations that are said to most often warrant punishment other than that required under section 1203 (late filed refund returns and employee versus employee allegations).

Complexity issues

The proposal has elements that may both increase and decrease complexity. The IRS must review and investigate every allegation of a section 1203 violation. Removing late filing of refund returns and employee versus employee conduct from the list of section 1203 violations may make it easier for the IRS to administer section 1203, as there would be fewer types of allegations that would require section 1203 review and investigation. Similarly, adding unauthorized inspection of returns to the list of violations may complicate IRS administration, as there would likely be an increase in the number of 1203 violations requiring IRS review and investigation. Additionally, because unauthorized inspection of returns violations under Code section 7213A are currently subject to discipline based on administrative determination by the IRS, adding such violations to the list of section 1203 violations would require the IRS to change current practice and follow section 1203 procedures instead.

Additional penalty guidelines may also either increase or decrease complexity. Additional guidelines may increase complexity by creating more rules for the IRS to establish and follow. The guidelines would also have to be periodically updated to ensure that punishments for specific violations continue to be appropriate. On the other hand, additional penalty guidelines may decrease complexity by providing clarity as to specific punishments for specific employee violations, which may enhance the IRS' effectiveness in administering section 1203.

Prior Action

An identical proposal was included in the President's fiscal year 2003, 2004, and 2005 budget proposals.[407] An identical proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. A substantially similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004.

[407] The original provisions were enacted in the IRS Restructuring and Reform Act of 1998.

2. Modifications with respect to frivolous returns and submissions

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[408] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Description of Proposal

The proposal modifies this IRS-imposed penalty by increasing the amount of the penalty to $5,000 for frivolous income tax returns.

The proposal also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are: (1) requests for a collection due process hearing; (2) installment agreements; and (3) offers-in-compromise. First, the proposal permits the IRS to dismiss such requests. Second, the proposal permits the IRS to impose a penalty of $5,000 for repeat behavior or failing to withdraw the request after being given an opportunity to do so.

The proposal permits the IRS to maintain administrative records of frivolous submissions by taxpayers.[409] The proposal also requires that this designation be removed after a reasonable period of time if the taxpayer makes no further frivolous submissions to the IRS.

The proposal requires the IRS to publish (at least annually) a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

Effective date.–The proposal is effective for submissions made on or after the date of enactment.

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[408] Because the Tax Court is the only pre-payment forum available to taxpayers, it handles the majority of cases brought by individuals contesting their tax liability. As a result, it also deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

[409] It is unclear how this portion of the proposal is intended to interact with the statutory prohibition on the designation of taxpayers by the IRS as "illegal tax protesters (or any similar designation)" (sec. 3707 of the Internal Revenue Service Restructuring and Reform Act of 1998; P.L. 105-206 (July 22, 1998)).

Analysis

In general

Genuinely frivolous returns and submissions are those that raise arguments that have been repeatedly rejected by the courts. Dealing with genuinely frivolous returns and submissions consumes resources at the IRS and in the courts that can better be utilized in resolving legitimate disputes with taxpayers. Accordingly, the proposals may improve the overall functioning of the tax system and improve the level of service provided to taxpayers who do not raise these frivolous arguments.

Some may question why this IRS-imposed penalty should be applied only to individuals instead of applying it to all taxpayers who raise frivolous arguments. Expanding the scope of the penalty to cover all taxpayers would treat similarly situated taxpayers who raise identical arguments in the same manner, which would promote fairness in the tax system. Similarly, some may question why this penalty should apply only to income tax returns and not to all other types of returns, such as employment tax and excise tax returns. Applying this penalty to all taxpayers and all types of tax returns would make this IRS-imposed penalty more parallel to the Tax Court penalty, where these constraints do not apply.

Complexity issues

Increasing the amount of an existing penalty arguably would have no impact on tax law complexity. It could be argued that the procedural changes made by the proposal, taken as a whole, would simplify tax administration by speeding the disposition of frivolous submissions, despite the fact that some elements of the proposals (such as the requirement to publish a list of frivolous positions) may entail increased administrative burdens.

Prior Action

A substantially similar proposal was included in the President's fiscal year 2003 budget proposal.[410] A substantially similar proposal was included in the President's fiscal year 2004 and 2005 budget proposals.[411] A substantially similar proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. A substantially similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004.

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[410] The fiscal year 2003 budget proposal also applied to taxpayer assistance orders and applied to all types of tax returns, not just income tax returns..

[411] The fiscal year 2004 and 2005 budget proposals applied to all types of tax returns, not just income tax returns.

3. Termination of installment agreements

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments, if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate or incomplete information when applying for an installment agreement; (5) there has been a significant change in the financial condition of the taxpayer; or (6) the collection of the tax is in jeopardy.[412]

Description of Proposal

The proposal grants the IRS authority to terminate an installment agreement when a taxpayer fails to timely make a required Federal tax deposit[413] or fails to timely file a tax return (including extensions). The termination could occur even if the taxpayer remained current with payments under the installment agreement.

Effective date.–The proposal is effective for failures occurring on or after the date of enactment.

Analysis

The proposal may lead to some additional complexity in the administration of installment agreements. For example, taxpayers might not understand why their installment agreement is being terminated, leading to additional phone calls to the IRS. In addition, the proposal would require that additional explanatory information be provided to taxpayers, which will increase complexity. It might be possible to reduce this increase in complexity by implementing these termination procedures in a manner as parallel as possible to the similar termination procedures

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[412] Sec. 6159(b).

[413] Failure to timely make a required Federal tax deposit is not considered to be a failure to pay any other tax liability at the time such liability is due under section 6159(b)(4)(B) because liability for tax generally does not accrue until the end of the taxable period, and deposits are required to be made prior to that date (sec. 6302).

for offers in compromise. It may also be beneficial to permit the reinstatement of terminated installment agreements for reasonable cause, parallel to the procedures applicable to offers in compromise.

The proposal reflects the policy determination that taxpayers who are permitted to pay their tax obligations through an installment agreement should also be required to remain current with their other Federal tax obligations. Some might be concerned that this does not take into account the benefits of making continued installment payments. A key benefit to the government of continued installment payments is that the government continues to receive payments, whereas if the installment agreement is terminated payments under that agreement stop. Some might note that termination of the installment agreement permits the IRS to begin immediate collection actions, such as reinstating liens and levies, which could increase government receipts. In the past several years, however, there has been a significant decline in IRS' enforced collection activities, so that others might respond that terminating installment agreements might not lead to increased receipts to the government, in that the cessation of receipts due to termination of installment agreements may outweigh increases in receipts through additional enforcement activities.

The proposal is effective for failures occurring on or after the date of enactment. Some may question whether it is fair to taxpayers who are currently in an installment agreement to terminate those agreements.

Prior Action

An identical proposal was included in the President's fiscal year 2003, 2004, and 2005 budget proposals. An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004.

4. Consolidate review of collection due process cases in the Tax Court

Present Law

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property (sec. 6330(a)). Similar rules apply with respect to liens (sec. 6320). The hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. That appeal must be brought to the United States Tax Court, unless the Tax Court does not have jurisdiction over the underlying tax liability. If that is the case, then the appeal must be brought in the district court of the United States (sec. 6330(d)). Special rules apply if the taxpayer files the appeal in the incorrect court.

The United States Tax Court is established under Article I of the United States Constitution[414] and is a court of limited jurisdiction.[415]

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[414] Sec. 7441.

Description of Proposal

The proposal consolidates all judicial review of these collection due process determinations in the United States Tax Court.

Effective date.–The proposal applies to IRS Office of Appeals determinations made after the date of enactment.

Analysis

Because the Tax Court is a court of limited jurisdiction, it does not have jurisdiction over all of the taxes (such as, for example, most excise taxes) that could be at issue in collection due process cases. The judicial appeals structure of present law was designed in recognition of these jurisdictional limitations; all appeals must be brought in the Tax Court unless that court does not have jurisdiction over the underlying tax liability. Accordingly, the proposal would give the Tax Court jurisdiction over issues arising from a collection due process hearing, while the Tax Court will not have jurisdiction over an identical issue arising in a different context.

The proposal would provide simplification benefits to taxpayers and to the IRS by requiring that all appeals be brought in the Tax Court, because doing so will eliminate confusion over which court is the proper venue for an appeal and will significantly reduce the period of time before judicial review.[416]

Some believe that present law "entitles a taxpayer patently seeking delay to achieve his goal by refiling in the District Court."[417] The proposal would provide simplification benefits by eliminating this opportunity for delay.

Prior Action

A substantially similar proposal was included in the President's fiscal year 2003 and 2004 budget proposals.[418] An identical proposal was included in the President's fiscal year 2005 budget proposal. An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004. The right to a hearing and

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[415] Sec. 7442.

[416] This reduction is attributable to the elimination of time periods built into the judicial review process to permit the refiling of appeals that have been filed with the wrong court.

[417] *Nestor v. Commissioner*, 118 T.C. No. 10 (February 19, 2002), concurring opinion by Judge Beghe.

[418] There was a slight difference in the effective dates of those proposals.

judicial review of the determinations made at these hearings were enacted in the IRS Restructuring and Reform Act of 1998.[419]

5. Office of Chief Counsel review of offers-in-compromise

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Amounts of $50,000 or more can only be accepted if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel (sec. 7122).

Description of Proposal

The proposal repeals the requirement that an offer-in-compromise of $50,000 or more must be supported by a written opinion from the Office of Chief Counsel. The Secretary must establish standards for determining when a written opinion is required with respect to a compromise.

Effective date.–The proposal applies to offers-in-compromise submitted or pending on or after the date of enactment.

Analysis

Repealing the requirement that an offer-in-compromise of $50,000 or more be supported by a written opinion from the Office of Chief Counsel will simplify the administration of the offer-in-compromise provisions by the IRS. Repealing this requirement also would increase the level of discretionary authority that the IRS may exercise, which may lead to increasingly inconsistent results among similarly situated taxpayers. Some may believe that Chief Counsel review is appropriate for all offers-in-compromise above specified dollar thresholds, similar to the review of large refund cases by the Joint Committee on Taxation.[420]

Prior Action

An identical proposal was included in the President's fiscal year 2003, 2004, and 2005 budget proposals. An identical proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. An

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[419] Sec. 3401(b) of P.L. 105-206 (July 22, 1998).

[420] Sec. 6405. The threshold for Joint Committee review is currently $2 million.

identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004. The $50,000 threshold was raised from $500 in 1996.[421]

[421] Sec. 503 of the Taxpayer Bill of Rights 2 (P.L. 104-168; July 30, 1996).

B. Initiate Internal Revenue Service ("IRS") Cost Saving Measures

1. Allow the Financial Management Service to retain transaction fees from levied amounts

Present Law

To facilitate the collection of tax, the IRS can generally levy upon all property and rights to property of a taxpayer (sec. 6331). With respect to specified types of recurring payments, the IRS may impose a continuous levy of up to 15 percent of each payment, which generally continues in effect until the liability is paid (sec. 6331(h)). Continuous levies imposed by the IRS on specified Federal payments are administered by the Financial Management Service (FMS) of the Department of the Treasury. FMS is generally responsible for making most non-defense related Federal payments. FMS is required to charge the IRS for the costs of developing and operating this continuous levy program. The IRS pays these FMS charges out of its appropriations.

Description of Proposal

The proposal allows FMS to retain a portion of the levied funds as payment of these FMS fees. The amount credited to the taxpayer's account would not, however, be reduced by this fee.

Effective date.–The provision is effective on the date of enactment.

Analysis

Proponents believe that altering the bookkeeping structure of these costs will provide for cost savings to the government.

Prior Action

An identical proposal was included in the President's fiscal year 2005 budget proposal. An identical proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004.

2. Extend the due date for electronically-filed tax returns and expand the authority to require electronic filing by large businesses and exempt organizations

Present Law

Extend the due date for electronically filed tax returns

In general, individuals must file their income tax returns and pay the full amount owed by April 15 (sec. 6072(a)). This deadline applies regardless of the method the taxpayer may choose to submit the tax return to the IRS. The Secretary may grant reasonable extensions of time for filing returns, but in general the time for paying tax may not be extended (sec. 6081(a)). Failure to file or pay on a timely basis may subject the taxpayer to interest and penalties.

Expand the authority to require electronic filing

The Code authorizes the IRS to issue regulations specifying which returns must be filed electronically.[422] There are several limitations on this authority. First, it can only apply to persons required to file at least 250 returns during the year.[423] Second, the IRS is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may by choice be filed electronically).

Description of Proposal

Extend the due date for electronically filed tax returns

The proposal extends the due date for filing and paying individual income taxes to April 30 provided that the taxpayer files the return electronically and pays the entire balance due electronically by that date. The due date for filing by any other method or for filing electronically but paying the balance due by non-electronic means is not changed.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2005; these returns will be filed in 2007.

Expand the authority to require electronic filing

The proposal expands the authority of the IRS to require businesses (including corporations, partnerships, and other business entities) and exempt organizations to file their returns electronically. The proposal statutorily lowers the number of returns that trigger the requirement to file electronically from 250 to "a minimum at a high enough level to avoid imposing an undue burden on taxpayers."[424] Taxpayers required to file electronically but who fail to do so would be subject to a monetary penalty, which could be waived for reasonable cause.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2005; these returns will be filed in 2007.

Analysis

Extend the due date for electronically filed tax returns

In general, the goal of the proposal is to reduce the administrative burdens on the IRS by encouraging more taxpayers to file and pay electronically. In particular, extending the date by which payment must be made could provide encouragement to file electronically to a significant

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[422] Sec. 6011(e).

[423] Partnerships with more than 100 partners are required to file electronically.

[424] Treasury General Explanations, p. 131.

number of filers of balance due returns, some of which are very complex. The proposal is, however, unlikely to cause a substantial increase in electronic filing for returns due a refund (which already constitute the vast majority of electronically filed returns) because one of the primary reasons those taxpayers file electronically is to receive their refunds more rapidly; a further extension of time to file contravenes that reason. The proposal would also reduce the administrative burdens on individual taxpayers to the extent that they prepare the tax return electronically but file a paper return by encouraging those individuals to file their returns electronically. The proposal could, in addition, encourage return preparers to file electronically, in that it will give the preparers additional time to prepare the returns.

Taxpayers must both file and pay electronically in order to receive the benefit of the proposed extension of time. There are currently three electronic mechanisms for paying the balance due[425] with the return: (1) credit card; (2) electronic funds withdrawal;[426] or (3) the Electronic Federal Tax Payment System (EFTPS).[427] Credit card providers charge a convenience fee[428] in addition to the amount of tax due, which may deter some individuals from paying the balance due electronically by credit card.

Another factor that may deter significant numbers of individuals from availing themselves of the extended Federal due date is whether States and local governments that impose income taxes provide parallel extensions of time to file. If they do not, and if the State or local income tax requires completion of the Federal return first (which many but not all do), taxpayers in those jurisdictions may not be able to avail themselves of the extended due date for Federal returns.

Although the proposal may in many instances reduce administrative burdens, having two different Federal filing deadlines could be considered to increase complexity. It would, for example, require explaining two filing deadlines, which is likely to be more complex than explaining one. Another factor that could affect complexity is whether all tax forms (or only some tax forms) will be eligible for electronic filing by the time the proposal becomes effective.

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[425] As an alternative, taxpayers could increase their wage withholding or estimated tax payments so as not to have a balance due with the return.

[426] This permits the IRS to withdraw the amount owed from the taxpayer's bank account electronically; it is not offered as an option when a paper return is filed. Taxpayers who file on paper are told in the instructions that they may pay by check or credit card; they are not told of the option of paying via EFTPS.

[427] This system, now used almost entirely by business taxpayers (principally to deposit payroll taxes), also accommodates individuals paying a balance due on their individual income tax returns or making estimated tax payments.

[428] The fee generally amounts to several percent of the total amount of taxes charged.

For the current tax filing season, many (but not all) tax forms are eligible for electronic filing.[429] If some forms cannot be filed electronically, taxpayers required to file those forms will be ineligible for this extension of time to file and pay. This could mean that taxpayers with especially complicated returns will be ineligible for this extension. If taxpayers are unaware in advance of their ineligibility to file electronically, ineligible taxpayers (erroneously believing they were eligible) might delay the filing of their returns until after April 15 intending to take advantage of this extension of time, then discover they are in fact ineligible and consequently inadvertently file late returns (owing interest and penalties).

Expand the authority to require electronic filing

The Congress set a goal for the IRS to have 80 percent of tax returns filed electronically by 2007. The overwhelming majority of tax returns are already prepared electronically. Thus, expanding the scope of returns that are required to be filed electronically may be viewed as both helping the IRS to meet the 80 percent goal set by the Congress and improving tax administration.

Prior Action

Extend the due date for electronically filed tax returns

A similar proposal was included in the President's fiscal year 2003 budget proposal. An identical proposal was included in the President's fiscal year 2004 and 2005 budget proposals. A similar proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003.

Expand the authority to require electronic filing

A similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate on May 19, 2004.

[429] See IRS Publication 1345A, Filing Season Supplement for Authorized IRS E-File Providers, pp. 20-1 (December 2004).

C. Other Provisions

1. Allow Internal Revenue Service ("IRS") to access information in the National Directory of New Hires ("NDNH")

Present Law

The Office of Child Support Enforcement of the Department of Health and Human Services ("HHS") maintains the National Directory of New Hires (NDNH), which is a database that contains: newly-hired employee data from Form W-4; quarterly wage data from state and federal employment security agencies; and unemployment benefit data from state unemployment insurance agencies. The NDNH was created to help state child support enforcement agencies enforce obligations of parents across state lines.

Under current provisions of the Social Security Act, the IRS may obtain data from the NDNH, but only for the purpose of administering the Earned Income Tax Credit (EIC) and verifying a taxpayer's employment that is reported on a tax return.

Under various state laws, the IRS may negotiate for access to employment and unemployment data directly from state agencies that maintain these data. Generally, the IRS obtains employment and unemployment data less frequently than quarterly, and there are significant internal costs of preparing these data for use.

Description of Proposal

The proposal amends the Social Security Act to allow the IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for non-compliant taxpayers, and identification of levy sources.

Effective date.–The proposal is effective upon enactment.

Analysis

The proposal could enhance tax administration by providing the IRS with a more efficient method to obtain taxpayer data. Obtaining taxpayer data from a centralized source such as the NDNH, rather than from separate State agencies, should increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing such data. Some may argue that allowing the IRS to access the NDNH for general tax administration purposes infringes on individual privacy and extends the use of the database beyond that which was originally intended; to enable state child support enforcement agencies to be more effective in locating noncustodial parents. On the other hand, data obtained by the IRS from the NDNH is protected by existing disclosure law. Thus, the proposal does not reduce the current levels of taxpayer privacy.

Prior Action

No prior action

2. Extension of authority for undercover operations

Present Law

IRS undercover operations are statutorily[430] exempt from the generally applicable restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the Code permits the IRS to "churn" the income earned by an undercover operation to pay additional expenses incurred in the undercover operation, through 2005. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations.

Description of Proposal

The proposal extends this authority through December 31, 2010.

Analysis

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

[430] Sec. 7608(c).

Prior Action

The provision was originally enacted in The Anti-Drug Abuse Act of 1988.[431] The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990[432] to December 31, 1991.[433] There followed a gap of approximately four and a half years during which the provision had lapsed. In the Taxpayer Bill of Rights II,[434] the authority to churn funds from undercover operations was extended for five years, through 2000.[435] The Community Renewal Tax Relief Act of 2000[436] extended the authority of the IRS to "churn" the income earned from undercover operations for an additional five years, through 2005.

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

[432] Sec. 3301 of Pub. L. 101-647 (Nov. 29, 1990).

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

[434] Sec. 1205 of Pub. L. 104-168 (July 30, 1996).

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

[436] Pub. L. 106-554.

D. Strengthen the Financial Integrity of Unemployment Insurance

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the net Federal unemployment tax rate 0.8 percent. Because all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. The net Federal unemployment tax revenue finances the administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. Also, additional distributions ("Reed Act distributions") may be made to the States, if the balance of the Federal unemployment trust funds exceeds certain statutory ceilings. The States use Reed Act distributions to finance their regular State programs (which are mainly funded with State unemployment taxes) and the other half of the Federal-State extended benefits program.

State Unemployment Insurance taxes are deposited into the State's Federal Unemployment Insurance Trust Fund and are used by the state to pay unemployment benefits. State recoveries of overpayments of Unemployment Insurance benefits must be similarly deposited and used exclusively to pay unemployment benefits. While States may enact penalties for overpayments, amounts collected as penalties or interest on benefit overpayments may be treated as general receipts by the States.

Under present law, all States operate experience rating systems. Under these systems an employer's State unemployment tax rate is based on the amount of unemployment benefits paid to the employer's former employees. Generally, the more unemployment benefits paid to former employees, the higher the State unemployment tax rates.

Description of Proposal

The proposal provides States with an incentive to recover unemployment benefit overpayments, and delinquent employer taxes. The proposal allows States to redirect up to five percent of overpayment recoveries to additional enforcement activity. The proposal requires States to impose a 15 percent penalty on recipients of fraudulent overpayments; the penalty would be used exclusively for additional enforcement activity.

Under the proposal, States also are required to take overpayments resulting from employer fault into account for purposes of the employer's experience rating account, even if the overpayment is later recovered. In certain circumstances relating to fraudulent overpayments or delinquent employer taxes, States are permitted to employ private collection agencies to retain a portion of such overpayments or delinquent taxes collected.

Finally, the proposal provides that the Secretary of the Treasury, upon request of a State, will reduce any income tax refund owed to a benefit recipient when that recipient owes a benefit overpayment to the requesting State.

Effective date.–The proposal is effective on January 1, 2006.

Analysis

States' abilities to reduce unemployment benefit overpayments and increase overpayment recoveries are limited by funding. In addition, the present-law requirement that States redeposit recoveries of overpayments to the Federal Unemployment Insurance Trust Fund creates a disincentive for States to increase enforcement activity. Permitting States to redirect five percent of overpayment recoveries to additional enforcement activity provides States with additional resources to detect and recover overpayments. The proposal also deters noncompliance by imposing a 15 percent penalty on fraudulent overpayments and provides States additional resources by requiring penalty proceeds to be used exclusively for enforcement activity. However, the proposal does not provide a definition of what will be considered fraudulent. The lack of a uniform definition of a fraudulent overpayment may result in disparate treatment of individuals in different States. In addition, there is a question as to whether the Federal government can ensure that amounts redirected from the Federal Unemployment Insurance Trust Fund are used exclusively for enforcement purposes.

The proposal also requires States to take overpayments resulting from employer fault into account for purposes of the employer's experience rating, even if the overpayment is later recovered. Proponents may argue this will decrease overpayments resulting from employer error. In addition, for employers with high error rates, the proposal ensures that the employer's State unemployment taxes are set at a level commensurate with the amount of unemployment benefits expected to be paid to the former employees of that employer. On the other hand, the proposal does not provide a definition of what will be considered employer fault. Without providing the States criteria for making this determination, there are issues regarding the administrability of such a standard.

The proposal permitting States to employ private collection agencies to retain a portion of certain fraudulent overpayments or delinquent employer taxes collected may permit States to more efficiently allocate resources to enforcement activities. The proposal does not, however, describe the circumstances when private collection agencies will be allowed to retain a portion of taxes collected and some may question whether it is appropriate to compensate such agencies based on the success in collecting taxes that are due.

There are administrability issues regarding the proposal requiring the Secretary to reduce any income tax refund owed to an unemployment benefit recipient when that recipient owes a overpayment to a State requesting offset. Present law provides States a limited right of offset with respect to legally enforceable State income tax obligations. Present law also establishes the priority of State income tax obligations relative to other liabilities. The proposal neither defines how the IRS will determine whether unemployment overpayments are legally owed to a State nor describes the relative priority of such offsets. Clarification of these elements is necessary to implement the proposal. Finally, some may question whether it is appropriate to provide States an offset right in non-income tax cases, thus, expanding the circumstances in which the Federal government acts a collection agent for the States.

Prior Action

No prior action

VII. REAUTHORIZE FUNDING FOR THE HIGHWAY TRUST FUND

A. Extend Excise Taxes Deposited in the Highway Trust Fund

Present Law

In general

Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. The remaining three are a retail sales tax on heavy highway vehicles, a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. The six taxes are summarized below.

Highway motor fuels taxes

The Highway Trust Fund motor fuels tax rates are as follows:[437]

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon
Special motor fuels	18.3 cents per gallon generally[438]

[437] Secs. 4081(a)(2)(A)(i), 4081(a)(2)(A)(iii), 4041(a)(2), 4041(a)(3), and 4041(m). Some of these fuels also are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund (secs. 4041(d) and 4081(a)(2)(B)).

[438] The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane)	13.6 cents per gallon (3.2 cents after September 30, 2005)
Liquefied natural gas	11.9 cents per gallon (2.8 cents after September 30, 2005)
Methanol derived from natural gas	9.15 cents per gallon (2.15 cents after September 30, 2005)
Compressed natural gas	48.54 cents per MCF

See secs. 4041(a)(2), 4041(a)(3) and 4041(m).

The compressed natural gas tax rate is equivalent only to 4.3 cents per gallon of the rate imposed on gasoline and other special motor fuels rather than the full 18.3-cents-per-gallon rate. The tax rate for the other special motor fuels is equivalent to the full 18.3-cents-per-gallon gasoline and special motor fuels tax rate.

Except for 4.3 cents per gallon of the Highway Trust Fund fuels tax rates, and a portion of the tax on certain special motor fuels, all of these taxes are scheduled to expire after September 30, 2005. The 4.3-cents-per-gallon portion of the fuels tax rates is permanent.

Non-fuel Highway Trust Fund excise taxes

In addition to the highway motor fuels excise tax revenues, the Highway Trust Fund receives revenues produced by three excise taxes imposed exclusively on heavy highway vehicles or tires. These taxes are:

- A 12-percent excise tax imposed on the first retail sale of heavy highway vehicles, tractors, and trailers (generally, trucks having a gross vehicle weight in excess of 33,000 pounds and trailers having such a weight in excess of 26,000 pounds) (sec. 4051);
- An excise tax imposed on highway tires with a rated load capacity exceeding 3,500 pounds, generally at a rate of 9.45 cents per 10 pounds of excess (sec. 4071(a)); and
- An annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more (sec. 4481). (The maximum rate for this tax is $550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds.)

The taxes on heavy highway vehicles and tires are scheduled to expire on September 30, 2005. The use tax applies only to uses before October 1, 2005.

Description of Proposal

The proposal would extend the motor fuel taxes and all three non-fuel excise taxes at their current rates through September 30, 2011.

Analysis

The President's FY06 Budget has proposed a spending level of $283.9 billion for the Highway Trust Fund reauthorization period FY 2004 through 2009. Ninety percent of Highway Trust Fund revenue comes from the motor fuel taxes. An extension of the current taxes dedicated to the Highway Trust Fund would continue to provide a significant funding source for highway programs.

The current mix of Highway Trust fund taxes reflects an attempt to assign tax burdens in relation to assumed damage to the highways done by the various industry segments. However, some may argue that the current rates do not reflect a proportionate cost allocation. As an example, in 2002, the Government Accountability Office noted a Federal Highway Administration report that heavy trucks (weighing over 55,000 pounds) cause a disproportionate

amount of damage to the nation's highways and, because the use tax is capped at $550, such trucks have not paid a corresponding share for the cost of the pavement damage they cause.[439]

In addition, some might argue that the non-fuel taxes supporting the Highway Trust Fund generate a relatively small amount of revenue, but require the IRS to devote significant resources to enforce. For example, the use tax subjects a large number of taxpayers to the tax for relatively small amounts, which might be viewed as an inefficient use of the IRS resources to enforce. The 12-percent retail sales tax is imposed on the first retail sale of the tractor, truck, or trailer. The term first retail sale includes the first sale of a "remanufactured vehicle".[440] Whether modifications to a vehicle constitute a "repair" or the manufacture of a new (remanufactured) vehicle involves significant factual determinations and is the subject of frequent disputes between the IRS and taxpayers. Thus, opponents of an extension may argue that the highly factual determinations in the application of the truck tax, and the large number of taxpayers subject to the use tax as compared with the revenue generated from the tax, result in an inefficient use of IRS resources in the enforcement of such taxes and weigh against extension of these taxes. On the other hand, the needs of the highway program continue to grow and since these industry segments make significant use of the nations highways, it is appropriate to continue to have these users contribute to the maintenance and improvement of the highway system.

Prior Action

The Highway Trust Fund Taxes were last extended in 1998 as part of the Transportation Equity Act for the 21st Century (TEA-21).[441] In the 108th Congress, H.R. 3550 (as passed by the House) would have extended these taxes through September 30, 2011. H.R. 3550 (as amended and passed by the Senate) would have extended these taxes through September 30, 2009.

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[439] General Accounting Office, GAO-02-667T, *HighwayFinancing: Factors Affecting Highway Trust Fund Revenues* (May 9, 2002) at 29.

[440] Sec. 4052(a).

[441] Pub. L. No. 105-178 (1998).

B. Allow Tax-Exempt Financing for Private Highway Projects and Rail-Truck Transfer Facilities

Present Law

Interest on bonds issued by States or local governments to finance activities of those governmental units is excluded from tax (sec. 103). In addition, interest on certain bonds ("private activity bonds") issued by States or local governments acting as conduits to provide financing for private businesses or individuals is excluded from income if the purpose of the borrowing is specifically approved in the Internal Revenue Code (sec. 141). Approved private activities for which States or local governments may provide tax-exempt financing include transportation facilities such as airports, ports, mass commuting facilities, and certain high-speed intercity rail facilities. High-speed intercity rail facilities eligible for tax-exempt financing include land, rail, and stations (but not rolling stock) for fixed guideway rail transportation of passengers and their baggage using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.

Description of Proposal

Two new categories of exempt facility bonds would be authorized to finance highway facilities and surface freight transfer facilities. Issuance of the bonds would not be subject to the general private activity bond volume cap, but rather would be subject to a separate volume limitation of $15 billion in the aggregate. The Secretary of Transportation would allocate the $15 billion of authority among eligible projects.

Highway facilities eligible for financing under the program would consist of any surface transportation project eligible for Federal assistance under Title 23 of the United States Code, or any project for an international bridge or tunnel for which an international entity authorized under Federal or State law is responsible. Surface freight transfer facilities would consist of facilities for the transfer of freight from truck to rail or rail to truck, including any temporary storage facilities directly related to those transfers. Examples of eligible surface freight transfer facilities would include cranes, loading docks and computer-controlled equipment that are integral to such freight transfers. Examples of non-qualifying facilities would include lodging, retail, industrial or manufacturing facilities.

Effective date.–The proposal is effective for bonds issued after date of enactment.

Analysis

Surface freight transfer facilities

Present law provides that private activity bonds may be issued for dock facilities and airport facilities. Dock and airport facilities eligible for private activity bonds include cranes and equipment integral to the loading and unloading of ships and planes and enabling the transfer of that cargo to other modes of transport. The proposal generally would treat rail and truck cargo exchanges comparably to ship to truck or rail exchanges.

Improved cargo transfers improve cargo delivery and reduce transportation costs, creating benefits for all consumers. The providers of truck and rail transportation services are private businesses. Generally, if there are cost-reducing efficiencies that can be achieved, a profit opportunity is created and private businesses will make investments to achieve these efficiencies. For example, private railroads invest in facilities and equipment to facilitate the transfer of freight from truck to rail and back to truck to provide so-called "piggyback" service. If the necessary investment to achieve a given level of cost reduction is too great for private business to achieve a reasonable rate of return on investment, the investment usually is not in the public's interest as the benefit to the consuming public is insufficient to justify the investment. However, some observe that current freight handling facilities may promote the consumption of additional fuels and result in pollution, imposing costs not borne directly by consumers in the price of delivered goods. A reduction in pollution may justify subsidies to the investment in freight handling facilities beyond that which would be provided by private business in the absence of such subsidies.

The ability to finance capital and operating costs with tax-exempt bonds may substantially reduce the cost of debt finance. To illustrate, assume the interest rate on taxable debt is 10 percent. If an investor in the 35 percent marginal income tax bracket purchased a taxable debt instrument, his after tax rate of return would be the 10 percent interest less a tax of 35 percent on the interest received for a net return of 6.5 percent. If as an alternative this investor could purchase a tax-exempt bond, all other things such as credit worthiness being equal, he would earn a better after tax return by accepting any tax-exempt yield greater than 6.5 percent.[442] In the market, the yield spread between a tax-exempt bond and comparable taxable bond is determined by the marginal buyer of the bonds; in today's market, yield spreads are generally less than 20 percent.[443] Because the yield spread arises from forgone tax revenue, economists say that tax-exempt finance creates an implicit subsidy to the issuer. However, with many investors in different tax brackets, the loss of Federal receipts is greater than the reduction in the

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[442] More generally, if the investor's marginal tax rate is t and the taxable bond yields r, the investor is indifferent between a tax-exempt yield, r_e, and $(1\text{-t})r$.

[443] For example, while not comparable in security, market trading recently has priced 30-year U.S. Treasuries (due in 26 years) to have a yield to maturity of approximately 4.68 percent. Prices for an index of long-term tax-exempt bonds have produced a yield to maturity of approximately 4.35 percent. See *The Bond Buyer,* February 23, 2005. Again ignoring differences in risk or other non-tax characteristics of the securities, the yield spread implies that an investor with a marginal tax rate of approximately 7 percent would be indifferent between the Treasury bond and the average high-quality tax-exempt bond. Thus, under present market conditions, yield spreads on long-term bonds are so narrow that almost all taxpayers investing in those instruments should prefer tax-exempt bonds. Viewed another way, almost the entire Federal subsidy to these bonds goes to bondholders (rather than State or local government issuers, or the private persons repaying the debt in the case of private activity bonds) under these market conditions.

tax-exempt issuers' interest saving.[444] The difference accrues to investors in tax brackets higher than those that would be implied by the yield spread between taxable and tax exempt bonds.

International bridges and tunnels

The proposal permits private activity bonds to be issued for international bridges or tunnels for which an international entity authorized under Federal or State law is responsible. Proponents of the proposal might argue that a private entity might be able to more effectively and efficiently manage such structures. In addition, having a private entity own the structure may provide additional capital for maintenance and upkeep. On the other hand, opponents might argue that the benefit from such international projects does not justify the decrease in Federal revenues that would result from the proposal.

Prior Action

On February 12, 2004, the Senate passed a similar proposal as part of S. 1072, the "Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2004."

[444] The Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone to a taxpayer in the 33-percent bracket costs the Federal Government $33, while the same amount of interest income forgone to a taxpayer in the 25-percent bracket costs the Federal Government $25. If a taxpayer in the 25-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 33-percent bracket will find it even more profitable. This conclusion implies that the Federal Government will lose more in revenue than the tax-exempt issuer gains in reduced interest payments.

VIII. EXPIRING PROVISIONS

A. Permanently Extend the Research and Experimentation ("R&E") Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after December 31, 2005.[445]

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[445] The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years. The research tax credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate university basic research credit.

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

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

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

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

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the research tax credit for three years--*i.e.*, retroactively from July 1, 1992 through June 30, 1995. The 1993 Act

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research

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also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience.

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

The Taxpayer Relief Act of 1997 ("1997 Act") extended the research credit for 13 months--*i.e.,* generally for the period June 1, 1997, through June 30, 1998. The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury). The Tax and Trade Relief Extension Act of 1998 extended the research credit for 12 months, *i.e.,* through June 30, 1999.

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

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

expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[446]

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

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

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[447] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four

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

A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

[447] Sec. 41(c)(4).

preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[448]

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

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

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[449] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (Sec. 280C(c)). Taxpayers may alternatively elect to claim a reduced research tax credit amount (13 percent) under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit is made permanent.

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

Analysis

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm are cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency.[450] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. However, there is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[451] Nevertheless, even if there were agreement that additional subsidies for research

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

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

[451] See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. XCIV, (1992), M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993, and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude

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

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

Scope of research activities in the United States and abroad

In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.8 percent of gross domestic product in 2002.[452] This rate of expenditure on research and development exceeds that of the European Union and the average of all countries that are members of the Organisation for Economic Co-operation and Development ("OECD"), but is less than that of Japan. See Figure 1, below. In 2001, expenditures on research and development in the United States represented 43.7 percent of all expenditures on research and development undertaken by OECD countries, were 55 percent greater than the total expenditures on research and development undertaken in the European Union, and were more than two and one half times such expenditures in Japan.[453] Expenditures on research and development in the United States have grown at an

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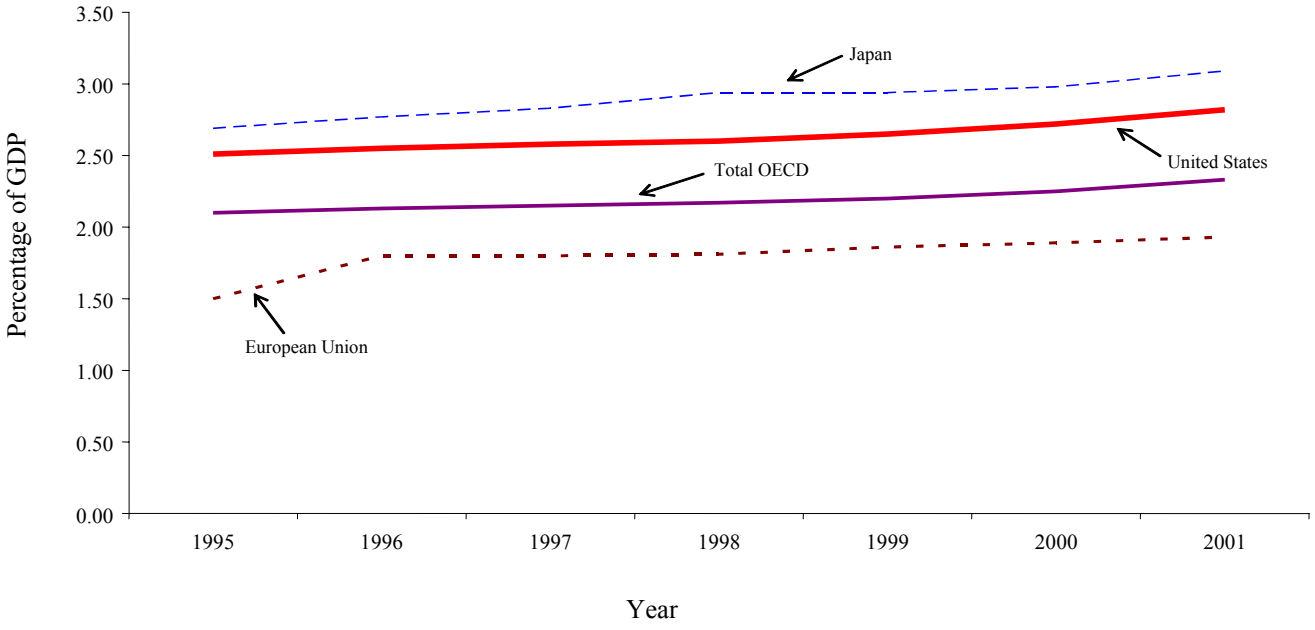
Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43.

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

[453] *Ibid.*

average real rate of 5.4 percent over the period 1995-2001. This rate of growth has exceeded that of Japan (2.8 percent), Germany (3.3 percent), France (2.4 percent for the period 1997-1999), Italy (2.7 percent for the period 1997-2000), and the United Kingdom, (2.3 percent), but is less than that of Canada (5.6 percent), Ireland (7.5 percent), and Spain (6.5 percent).[454]

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



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

The scope of present-law tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit is estimated to be $4.8 billion for 2005. The related tax expenditure for expensing of research and development expenditures was estimated to be $4.0 billion for 2005 growing to $6.3 billion for 2009.[455] As noted above, the Federal Government also directly subsidizes research activities. For example,

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

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

in fiscal 2004, the National Science Foundation made $4.0 billion in grants, subsidies, and contributions to research activities, the Department of Defense financed $11.5 billion in basic research, applied research, and advanced technology development, and the Department of Energy financed $0.7 billion in research in high energy physics, $1.0 billion in basic research in the sciences, $0.6 billion in biological and environmental research, and $197 million for research in advance scientific computing.[456]

Table 6 and Table 7 present data for 2002 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. In 2002, more than 15,000 taxpayers claimed more than $5.8 billion in research tax credits.[457] Taxpayers whose primary activity is manufacturing claimed two thirds of the research tax credits claimed. Firms with assets of $50 million or more claimed nearly 85 percent of the credits claimed. Nevertheless, as Table 7 documents, a large number of small firms are engaged in research and were able to claim the research tax credit.

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

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

Table 6.–Percentage Distribution of Firms Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2002

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

[1] Data undisclosed to protect taxpayer confidentiality.

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

Table 7.–Percentage Distribution of Firms Claiming Research Tax Credit and of Amount of Credit Claimed by Firm Size, 2002

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

Note: Totals may not add to 100 percent due to rounding.
Source: Joint Committee on Taxation calculations from Internal Revenue Service, Statistics of Income data.

Flat or incremental tax credits?

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

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

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

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

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

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

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

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of price elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[458] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[459]

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

[459] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken

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

> In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of -0.2 and -0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[460]

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

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otherwise--so called marginal research expenditures--need be subject to the credit to have a positive incentive effect.

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

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

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

> [W]ork using US firm-level data all reaches the same conclusion: the tax price elasticity of total R&D spending during the 1980s is on the order of unity, maybe higher. … Thus there is little doubt about the story that the firm-level publicly reported R&D data tell: the R&D tax credit produces roughly a dollar-for-dollar increase in reported R&D spending on the margin.[461]

However this survey notes that most of this evidence is not drawn directly from tax data. For example, effective marginal tax credit rates are inferred from publicly reported financial data and may not reflect limitations imposed by operating losses or the alternative minimum tax. The

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

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

study notes that because most studies rely on "reported research expenditures" that a "relabelling problem" may exist whereby a preferential tax treatment for an activity gives firms an incentive to classify expenditures as qualifying expenditures. If this occurs, reported expenditures increase in response to the tax incentive by more than the underlying real economic activity. Thus, reported estimates may overestimate the true response of research spending to the tax credit.[462]

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

Other policy issues related to the research and experimentation credit

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

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

If a firm has no current tax liability, or if the firm is subject to the alternative minimum tax ("AMT") or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[463]

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

Although the statutory rate of the research credit is currently 20 percent, it is likely that the average marginal effective rate may be substantially below 20 percent. Reasonable

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[462] Hall and Van Reenen, "How effective are fiscal incentives for R&D? A review of the evidence," p. 463.

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

assumptions about the frequency that firms are subject to various limitations discussed above yield estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, i.e., between 12 and 15 percent.[464]

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will drift from the firm's actual current qualified research expenditures. Therefore, increasingly over time there will be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms receive no credit and have no reasonable prospect of ever receiving a credit, while other firms receive large credits (despite the 50-percent base amount limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average marginal effective rate of credit will decline while the revenue cost to the Federal Government increases.

Complexity and the research tax credit

Administrative and compliance burdens also result from the present-law research tax credit. The General Accounting Office ("GAO") has testified that the research tax credit is difficult for the IRS to administer. The GAO reported that the IRS states that it is required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes. While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.[465] An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

> Tax incentives such as the R&D tax credit … typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. … [I]s what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit

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

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

under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.[466]

Prior Action

The President's fiscal year 2003, 2004, and 2005 budget proposals contained an identical provision.

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

B. Permanently Extend and Expand Disclosure of Tax Return Information for Administration of Student Loans

Present Law

Income-contingent loan verification program

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.[467] An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.[468] The Department of Education disclosure authority is scheduled to expire after December 31, 2005.[469]

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.[470] Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather than under the specific exception.[471] The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[472]

Verifying financial aid applications

The Higher Education Act of 1998 ("Higher Education Act") authorized the Department of Education to confirm with the Internal Revenue Service four discrete items of return information for the purposes of verifying of student aid applications.[473] The Higher Education Act, however, did not amend the Code to permit disclosure for this purpose. Therefore, the

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[467] Sec. 6103.

[468] Sec. 6103(l)(13).

[469] Pub. L. No. 108-311 (2004).

[470] Sec. 6103(c).

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

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

[473] Pub. L. No. 105-244, sec. 483 (1998).

disclosure provided by the Higher Education Act may not be made unless the taxpayer consents to the disclosure under section 6103(c).

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

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

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

Overpayments of Pell grants and defaulted student loans

For purposes of locating a taxpayer to collect an overpayment of a Federal Pell grant or to collect payments on a defaulted loan, the Internal Revenue Service may disclose the taxpayer's mailing address to the Department of Education.[474] To assist in locating the defaulting taxpayer, the Department of Education may redisclose the mailing address to the officers, employees and agents of certain lenders, States, nonprofit agencies, and educational institutions whose duties relate to the collection of student loans.[475]

Safeguard procedures and recordkeeping

Federal and State agencies that receive returns and return information are required to maintain a standardized system of permanent records on the use and disclosure of that information.[476] Maintaining such records is a prerequisite to obtaining and continuing to obtain returns and return information. Such agencies must also establish procedures satisfactory to the IRS for safeguarding the information it receives. The IRS must also file annual reports with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation regarding procedures and safeguards followed by recipients of return and return information.[477]

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[474] Sec. 6103(m)(4).

[475] *Id*.

[476] Sec. 6103(p)(4).

[477] Sec. 6103(p)(5).

Description of Proposal

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

The proposal allows the Department of Education to use contractors to process the information disclosed to the Department of Education, eliminating the need for consents. It is understood that the proposal imposes the present-law safeguards applicable to disclosures to Federal and State agencies on disclosures to the Department of Education and its contractors.

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

Analysis

Contractors

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

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

Burdens on IRS

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

Income contingent loan verification program

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

Verifying financial aid applications

Congress has expressed a concern about the increasing number of requests for the disclosure of confidential tax information for nontax purposes and the effect of such disclosures on voluntary taxpayer compliance.[478] Some might argue that consensual disclosure of return information, in which the taxpayer knowingly consents to the disclosure of his or her return information ("consents"), is less likely to adversely impact taxpayer compliance than adding a nonconsensual provision for the disclosure of taxpayer information. Since the Internal Revenue Service is already processing consents for the Department of Education, some would argue that the current practice simply could be extended to financial aid applications.[479] On the other hand, some might argue that because present law does not impose restrictions on redisclosure of return information obtained by consent, the proposal, which imposes such restrictions, would be preferable.

Critics might argue that the disclosure of sensitive return information of millions[480] of taxpayers to identify the abuse of a few does not strike the appropriate balance between the need to know and the right to privacy. On the other hand, some might argue that since this financial information is already required to be submitted as part of the financial aid form, the infringement on taxpayer privacy is minimal.

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[478] S. Prt. No. 103-37 at 54 (1993).

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

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

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004 and 2005 budget proposals.

C. Extend and Modify the Work Opportunity Tax Credit and Welfare-to-Work Tax Credit

Present Law

Work opportunity tax credit

Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

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

Qualified wages

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

Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

Minimum employment period

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

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

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

Other rules

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

Expiration date

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

Welfare-to-work tax credit

Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family that is no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than for the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax credit which includes simply cash wages, the definition of wages for the welfare-to-work tax credit includes cash wages paid to an employee plus amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. The employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients during the first two years of employment. The maximum credit is 35 percent of the first $10,000 of qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Qualified first-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted

group during the one-year period beginning with the day the individual began work for the employer. Qualified second-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning immediately after the first year of that individual's employment for the employer. The maximum credit is $8,500 per qualified employee.

Minimum employment period

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

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

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

Other rules

The welfare-to-work tax credit incorporates directly or by reference many of these other rules contained on the work opportunity tax credit.

Expiration date

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

Description of Proposal

Combined credit

The proposal combines the work opportunity and welfare-to-work tax credits and extends the combined credit for one year.

Targeted groups eligible for the combined credit

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

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

Qualified wages

Qualified first-year wages for the eight WOTC categories remain capped at $6,000 ($3,000 for qualified summer youth employees). No credit is allowed for second-year wages. In the case of long-term family assistance recipients the cap is $10,000 for both qualified first-year wages and qualified second-year wages. For all targeted groups, the employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

First-year wages.–For the eight WOTC categories, the credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee for members of any of the eight WOTC targeted groups generally is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit remains $1,200 (40 percent of the first $3,000 of qualified first-year wages). For the welfare-to-work/long-term family assistance recipients, the maximum credit equals $4,000 per employee (40 percent of $10,000 of wages).

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

Minimum employment period

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

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

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

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

Analysis

Overview of policy issues

The WOTC is intended to increase the employment and earnings of targeted group members. The credit is made available to employers as an incentive to hire members of the targeted groups. To the extent the value of the credit is passed on from employers to employees, the wages of target group employees will be higher than they would be in the absence of the credit.[481]

The rationale for the WOTC is that employers will not hire certain individuals without a subsidy, because either the individuals are stigmatized (e.g., convicted felons) or the current

[481] For individuals with productivity to employers lower than the minimum wage, the credit may result in these individuals being hired and paid the minimum wage. For these cases, it would be clear that the credit resulted in the worker receiving a higher wage than would have been received in the absence of the credit (e.g., zero).

productivity of the individuals is below the prevailing wage rate. Where particular groups of individuals suffer reduced evaluations of work potential due to membership in one of the targeted groups, the credit may provide employers with a monetary offset for the lower perceived work potential. In these cases, employers may be encouraged to hire individuals from the targeted groups, and then make an evaluation of the individual's work potential in the context of the work environment, rather than from the job application. Where the current productivity of individuals is currently below the prevailing wage rate, on-the-job-training may provide individuals with skills that will enhance their productivity. In these situations, the WOTC provides employers with a monetary incentive to bear the costs of training members of targeted groups and providing them with job-related skills which may increase the chances of these individuals being hired in unsubsidized jobs. Both situations encourage employment of members of the targeted groups, and may act to increase wages for those hired as a result of the credit.

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

Efficiency of the credit

The credit provides employers with a subsidy for hiring members of targeted groups. For example, assume that a worker eligible for the credit is paid an hourly wage of w and works 2,000 hours during the year. The worker is eligible for the full credit (40 percent of the first $6,000 of wages), and the firm will receive a $2,400 credit against its income taxes and reduce its deduction for wages by $2,400. Assuming the firm faces the full 35-percent corporate income tax rate, the cost of hiring the credit-eligible worker is lower than the cost of hiring a credit-ineligible worker for 2,000 hours at the same hourly wage w by 2,400 (1-.35) = $1,560.[482] This $1,560 amount would be constant for all workers unless the wage (w) changed in response to whether or not the individual was a member of a targeted group. If the wage rate does not change in response to credit eligibility, the WOTC subsidy is larger in percentage terms for lower wage workers. If w rises in response to the credit, it is uncertain how much of the subsidy remains with the employer, and therefore the size of the WOTC subsidy to employers is uncertain.

To the extent the WOTC subsidy flows through to the workers eligible for the credit in the form of higher wages, the incentive for eligible individuals to enter the paid labor market may increase. Since many members of the targeted groups receive governmental assistance (e.g., Temporary Assistance for Needy Families or food stamps), and these benefits are phased out as income increases, these individuals potentially face a very high marginal tax rate on additional earnings. Increased wages resulting from the WOTC may be viewed as a partial offset

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

to these high marginal tax rates. In addition, it may be the case that even if the credit has little effect on observed wages, credit-eligible individuals may have increased earnings due to increased employment.

The structure of the WOTC (the 40-percent credit rate for the first $6,000 of qualified wages) appears to lend itself to the potential of employers churning employees who are eligible for the credit. This could be accomplished by firing employees after they earn $6,000 in wages and replacing them with other WOTC-eligible employees. If training costs are high relative to the size of the credit, it may not be in the interest of an employer to churn such employees in order to maximize the amount of credit claimed. Empirical research in this area has not found an explicit connection between employee turnover and utilization of WOTC's predecessor, the Targeted Jobs Tax Credit ("TJTC").[483]

Job creation

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

In addition, windfall gains to employers or employees may accrue when the WOTC is received for workers that the firm would have hired even in the absence of the credit. When windfall gains are received, no additional employment has been generated by the credit. Empirical research on the employment gains from the TJTC has indicated that only a small portion of the TJTC-eligible population found employment because of the program. One study indicates that net new job creation was between five and 30 percent of the total certifications. This finding is consistent with some additional employment as a result of the TJTC program, but with considerable uncertainty as to the exact magnitude.[484]

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

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

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

individual.[485] In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

Complexity issues

Extension of the provision for one year provides some continuity and simplifies tax planning during that period for taxpayers and practitioners. Some may argue that a permanent extension will have a greater stabilizing effect on the tax law. They point out that temporary expirations, like the current one, not only complicate tax planning but also deter some taxpayers from participating in the program. Others who are skeptical of the efficacy of the WOTC program may argue that not extending the credit could eliminate a windfall benefit to certain taxpayers and permanently reduce complexity in the Code.

Prior Action

Separate proposals to extend the two credits without combining them were included in the President's fiscal year 2002 and 2003 budget proposals.[486] A similar proposal was included in the President's fiscal year 2004 and 2005 budget proposals.

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

[486] Pub. L. No. 107-147, "The Job Creation and Worker Assistance Act of 2002," extended the credit for two years.

D. Extend District of Columbia Homebuyer Tax Credit

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2005.[487]

Description of Proposal

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

Effective date.–The proposal is effective for residences purchased after December 31, 2005.

Analysis

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

A number of policy issues are raised with respect to whether the D.C. homebuyer credit should be extended. One issue is whether it is the proper role of the Federal government to

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[487] Sec. 1400C(i). The District of Columbia first-time homebuyer credit was enacted as part of the Taxpayer Relief Act of 1997, and was scheduled to expire on December 31, 2000. The Tax Relief Extension Act of 1999 extended the first-time homebuyer credit for one year, through December 31, 2000. The Community Renewal Tax Relief Act of 2000 extended the first-time homebuyer credit for two additional years, through December 31, 2003. The Working Families Tax Relief Act of 2004 extended the first-time homebuyer credit for two additional years, through December 31, 2005.

distort local housing markets by favoring the choice of home ownership in one jurisdiction over another. Favoring home ownership in one area comes at the expense of home ownership in adjacent areas. Thus, if the credit stimulates demand in the District of Columbia, this comes at the expense of demand in other portions of the relevant housing market, principally the nearby suburbs of Virginia and Maryland.

To the extent that local jurisdictions vary in their tax rates and services, individuals purchasing a home may choose to buy in the jurisdiction that offers them the combination of tax rates and services and other amenities that they desire.[488] If a jurisdiction has a low tax rate, some might choose it on that basis. If a jurisdiction has a high tax rate but offers a high level of services, some will decide that the high tax rate is worth the services and will choose to buy in that jurisdiction. If tax rates are high but services are not correspondingly high, individuals may avoid such jurisdictions. It is in part this individual freedom to choose where to live that can promote competition in the provision of local public services, helping to assure that such services are provided at reasonable tax rates. If a jurisdiction fails at providing reasonable services at reasonable tax rates, individuals might choose to move to other jurisdictions. This may cause property values in the jurisdiction to fall and, together with taxpayer departures, may put pressure on the local government to change its behavior and improve its services. If the Federal government were to intervene in this market by encouraging the purchase of a home in one local market over another, competition among local jurisdictions in the provision of public services may be undermined.

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

Some argue that the credit is appropriate because a number of factors distinguish the District of Columbia from other cities or jurisdictions and that competition among the District and neighboring jurisdictions is constrained by outside factors. For example, some argue that the credit is a means of compensating the District for an artificially restricted tax base. While many residents of the suburbs work in the District and benefit from certain of its services, the Federal government precludes the imposition of a "commuter tax," which is used by some other jurisdictions to tax income earned within the jurisdiction by workers who reside elsewhere. In addition, some argue that the District has artificially reduced property, sales, and income tax revenues because the Federal government is headquartered in the District. The Federal government makes a payment to the District to compensate for the forgone revenues, but some argue that the payment is insufficient. Some also argue that to the extent migration from the District is a result of a high tax rate and poor services, it is not entirely within the control of the

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

District to fix such problems, because the District government is not autonomous, but is subject to the control of Congress.

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

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

Prior Action

A similar proposal was included in the President's fiscal year 2004 and 2005 budget proposals. The 2005 proposal suggested extension of the credit for two years, through 2005.

E. Extend Authority to Issue Qualified Zone Academy Bonds

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103). An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt (sec. 149(e)). Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds does not apply to any arbitrage bond (secs. 103(a) and (b)(2)). An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments (sec. 148). In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds was authorized to be issued annually in calendar years 1998 through 2005. The $400 million aggregate bond cap was allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocated the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

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

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers

and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

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

Description of Proposal

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

Effective date.–The provision is effective generally for bonds issued after the date of enactment.

Analysis

Policy issues

The proposal to extend qualified zone academy bonds would subsidize a portion of the costs of new investment in public school infrastructure and, in certain qualified areas, equipment and teacher training. By subsidizing such costs, it is possible that additional investment will take place relative to investment that would take place in the absence of the subsidy. If no additional investment takes place than would otherwise, the subsidy would merely represent a transfer of funds from the Federal Government to States and local governments. This would enable States and local governments to spend the savings on other government functions or to reduce taxes.[489] In this event, the stated objective of the proposals would not be achieved.

Though called a tax credit, the Federal subsidy for tax credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or

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

local government that benefits from the bond proceeds.[490] To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal Government would make outlays of $100 in interest payments, but would recoup $28 of that in tax receipts, for a net budgetary cost of $72, as before. Similarly, the bondholder/taxpayer would receive a taxable $100 in interest, and would owe $28 in taxes, for a net gain of $72, as before. The State or local government also would be in the same situation in both cases.

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

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

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

for issuers to issue more bonds and to issue them earlier than necessary,[491] which increases the cost of the subsidy. On the other hand, the lack of arbitrage or rebate requirements for qualified zone academy bonds subsidizes the repayment of principal on such bonds, as well as other qualified expenditures, by allowing issuers to invest proceeds at unrestricted yields and retain the earnings from such investments. Opponents to the imposition of arbitrage or rebate requirements may argue that such restrictions will decrease the amount of subsidy available to assist schools with significant needs, but limited means through which to satisfy those needs.

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

Complexity issues

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

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

The proposal's reporting requirements may assist in the monitoring of the use of these bonds. On the other hand, it will add to complexity in that it imposes a requirement not previously applied to qualified zone academy bonds. In addition, the proposal increases the paperwork burden on issuers in that forms must be completed and filed with the IRS.

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

Prior Action

Similar proposals were included in the President's fiscal year 2003, 2004, and 2005 budget proposals.

F. Extend Deduction for Corporate Donations of Computer Technology

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[492]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[493] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2005.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.[494] The original use of the property must be by the donor or the donee,[495] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a

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[492] Sec. 170(e)(1).

[493] Secs. 170(e)(4) and 170(e)(6).

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

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

related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.[496]

Description of Proposal

The proposal extends the enhanced deduction to apply to donations made in taxable years beginning after December 31, 2005 and to donations made in taxable years beginning before January 1, 2007.

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

Analysis

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

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

The proposal, as does present law, creates complexities for the taxpayer and the IRS. The enhanced deduction is allowed to the donor only for equipment that the donee does not trade or sell. Generally, once the equipment is in the hands of the donee it is difficult for the donor to

[496] Sec. 170(e)(6)(C).

monitor the use of the equipment. Likewise, it is difficult for the IRS to ascertain whether a claim for an enhanced deduction is valid. Also, the proposal, as does present law, predicates the enhanced deduction on an ascertainable fair market value of the computer technology.[497] With the rapid advances in the field, such determinations are difficult at times. Computers lose value quickly.[498] However, third-party tracking of prices for used computer equipment do exist. In this regard, the limitation to equipment less than three years old may aid taxpayer compliance and IRS administration. Nonetheless, because value is uncertain, the IRS is at a disadvantage in enforcing the provision. To ease administration and provide greater certainty for taxpayers and the IRS, the enhanced deduction generally could be based not on the value of the computer equipment but on the taxpayer's basis in the equipment and the equipment's age. For example, equipment one year old or less could receive a deduction of up to twice the taxpayer's basis; equipment between one and two years old could receive a deduction of a lesser multiple of the taxpayer's basis; and equipment two years old or greater could receive a deduction of an even lesser multiple of the taxpayer's basis.[499] The reduction in the deduction over time could be justified by the generally rapid decrease in value of computer equipment over time. The deduction still would be an enhanced deduction because the taxpayer would receive more than its basis in the property. Under such an alternative, the basis multiple would have to be determined based on information about the markup of new items and the rate of loss of value over time. However, assuming that the relationship between value and basis varies over time, the basis multiple should be adjusted regularly.

Taxpayers who contribute computer equipment from inventory must consider multiple factors to ensure that they deduct the permitted amount (and no more than the permitted amount) with respect to contributed equipment. Taxpayers who are required to maintain inventories for such items must consider the fair market value of the contributed equipment, the basis of the equipment (and twice the basis of the equipment), and the resulting income that would be

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

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

[499] As under present law, the deduction could not exceed fair market value.

realized if the equipment were sold, and coordinate the resulting contribution deduction with the determination of cost of goods sold.[500]

Prior Action

An identical proposal was part of the President's fiscal year 2004 and 2005 budgets.

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

G. Extend Provisions Permitting Disclosure of Tax Return Information Relating to Terrorist Activity

Present Law

In general

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

Among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term "terrorist incident, threat, or activity" is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms are defined in the USA PATRIOT Act.[501]

In general, returns and taxpayer return information must be obtained pursuant to an *ex parte* court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. No disclosures may be made under this provision after December 31, 2005.

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

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

The Code permits, pursuant to an *ex parte* court order, the disclosure of returns and return information (including taxpayer return information[502]) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

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[501] 18 U.S.C. 2331.

[502] "Taxpayer return information" is return information that is filed with, or furnished to, the Secretary by or on behalf of the taxpayer to whom such return information relates.

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

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

If the Secretary of Treasury possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary of the Treasury (or his delegate), may on his own initiative, authorize an application for an *ex parte* court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary of the Treasury in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS *ex parte* court order.

Disclosure of return information other than by ex parte court order

Disclosure by the IRS without a request

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

Disclosure upon written request of a Federal law enforcement agency

The Code permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. A taxpayer's identity is not treated as taxpayer return

information for this purpose and may be disclosed under this authority. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Code permits the head of a Federal law enforcement agency to redisclose return information received, in response to the written request described above, to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis. A taxpayer's identity is not treated as taxpayer return information for this purpose and may be disclosed under this authority.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester under the Act.

Description of Proposal

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

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

Analysis

The temporary nature of the present-law provision introduces a degree of uncertainty regarding the disclosure of return information relating to terrorist activities, i.e., whether the

provision will be the subject of further extensions. There has been no study of the effectiveness of the provisions.

According to IRS accountings of disclosures made under the authority of the provisions in calendar year 2002, the IRS reported 39 disclosures to the Federal Bureau of Investigation under the terrorist activity provisions governing IRS-initiated disclosures to Federal law enforcement.[503] However, the IRS used its authority to make disclosures in emergency circumstances to make an additional 12,236 disclosures to the FBI. The IRS made 25 disclosures to the Department of Justice for purposes of preparing an application for an *ex parte* court order to permit the IRS to initiate an affirmative disclosure of returns and return information. Pursuant to the *ex parte* court order authority, 2,215 disclosures were made to U.S. Attorneys in calendar year 2002. The IRS did not report any terrorist activity disclosures to Federal intelligence agencies, nor did it report any disclosures in response to requests from Federal law enforcement agencies for calendar year 2002.

For calendar year 2003, 1,626 disclosures were made under the terrorist activity provisions governing IRS disclosures to Federal law enforcement. Under the *ex parte* court order authority, 1,724 disclosures were made to U.S. Attorneys in calendar year 2003. The IRS did not report any disclosures to Federal intelligence agencies or in response to requests from Federal law enforcement agencies for calendar year 2003.[504] This limited usage could be an indication that further extension of the provision is not warranted. On the other hand, this may not be a significant number of disclosures to evaluate the effectiveness of the provision. An additional temporary extension provides additional time to evaluate the effectiveness of the provision and whether any modifications need to be implemented to enhance the provision.

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

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

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

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

Prior Action

A similar proposal was included in the President's fiscal year 2005 budget proposals.

H. Extend Excise Taxes Deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund

Present Law

The Code imposes an excise tax, generally at a rate of 0.1 cents per gallon, on gasoline, diesel, kerosene, and special motor fuels[505], used on highways, in aviation, on inland waterways and in diesel-powered trains. The taxes are deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund. The tax expires on March 31, 2005.

Description of Proposal

The LUST Trust Fund tax is extended at the current rate through March 31, 2007.

Analysis

The LUST Trust Fund enables the Environmental Protection Agency and States to pay the costs of responding to leaking underground storage tanks when the tank owners fail to do so, or in an emergency situation, and to oversee LUST cleanup activities by responsible parties.[506] Thus, an extension of the tax would ensure the availability of funds for these activities.

On the other hand, some may contend that based on historical appropriations, the Trust Fund has sufficient funds on hand. At the end of FY 2004, the LUST Trust Fund's net assets were $2.24 billion. In FY 2004, the LUST tax generated $192.9 million in revenues, and the fund earned $66.7 million in interest. Historically, authorized appropriations from the Trust Fund have ranged from $70 to $76 million. For FY 2003, Congress authorized appropriations of $72.3 million. For FY 2004, Congress appropriated approximately $76 million, and in FY 2005, Congress provided $70 million.[507]

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[505] The tax does not apply to liquefied petroleum gas and liquefied natural gas. Sec. 4041(d)(1).

[506] An underground storage tank system ("UST") is a tank and any underground piping connected to the tank that has at least 10 percent of its combined volume underground. The Federal UST regulations apply only to underground tanks and piping storing either petroleum or certain hazardous substances. According to the Environmental Protection Agency, the greatest potential hazard from a leaking UST is that the petroleum or other hazardous substance can seep into the soil and contaminate groundwater. A leaking UST can also present other health and environmental risks, including fire and explosion. U.S. Environmental Protection Agency, *Overview of the Federal Underground Storage Tank Program* http://www.epa.gov/swerust1/overview.htm (visited February 23, 2005).

[507] Congressional Research Service, *Leaking Underground Storage Tanks: Program Status and Issues*, RS21201 (January 3, 2005) at CRS-3 (hereinafter "CRS Report"). These LUST Trust Fund appropriations for FY2003-FY2005 do not reflect the mandatory, across-the-board recissions that Congress applied to the appropriations acts that funded EPA programs and

Proponents of an extension may argue that an extension is justified because there is a significant backlog of sites requiring remedial action (129,827).[508] In addition, the discovery of the gasoline additive methyl tertiary butyl ether ("MTBE") at thousands of LUST sites is a major concern.[509] Corrective action for leaks that affect groundwater typically cost from $100,000 to over $1 million, depending on the extent of contamination.[510] The presence of MTBE can lead to a substantial increase in cleanup and drinking water treatment costs.[511] Energy bills from the 108th Congress sought to broaden the use of Trust Fund monies, increasing Trust Fund appropriations to clean up MTBE leaks, and adding new leak prevention and enforcement provisions to the underground storage tank program.[512] In light of these possible new uses of the fund, some might argue that past appropriations are not indicative of the future needs of the LUST Trust Fund program.

Prior Action

The Superfund Revenue Act of 1986 created the LUST Trust Fund. The taxing authority expired in December 1995. Congress reinstated the tax from October 1, 1997, through March 31, 2005.[513]

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activities for FY2003-FY2005. The mandatory recission amounts applied for these years were: 0.65% for FY2003; 0.59% for FY2004; and 0.8% for FY2005.

[508] This figure is as of September 2004. See U.S. Environmental Protection Agency, *UST Program Facts* (February 2005).

[509] CRS Report at CRS-1.

[510] U.S. Environmental Protection Agency, *Leaking Underground Storage Tank (LUST)Trust Fund* <http://www.epa.gov/swerust1/ltfacts.htm> (visited February 23, 2005).

[511] *Id*. MTBE is very water soluble and moves through soil into water more rapidly than other gasoline components. CRS Report at CRS-4.

[512] See e.g. H.R. 6 and S. 2095 (108th Cong.). For a comprehensive list of bills introduced in the 108th Congress on this topic see CRS Report at CRS-5-6.

[513] Pub. L. No. 105-34, sec. 1033 (1997).

I. Extend Excise Tax on Coal at Current Rates

Present Law

A $1.10 per ton excise tax is imposed on coal sold by the producer from underground mines in the United States. The rate is 55 cents per ton on coal sold by the producer from surface mining operations. The tax cannot exceed 4.4 percent of the coal producer's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Disability Trust Fund to finance benefits under the Federal Black Lung Benefits Act. Currently, the Black Lung Disability Trust Fund is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates are scheduled to decline to 50 cents per ton for underground-mined coal and 25 cents per ton for surface-mined coal (and the cap is scheduled to decline to two percent of the selling price) for sales after January 1, 2014, or after any earlier January 1 on which there is no balance of repayable advances from the Black Lung Disability Trust Fund to the General Fund and no unpaid interest on such advances.

Description of Proposal

The proposal retains the excise tax on coal at the current rates until the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the General Fund. After repayment of the Trust Fund's debt, the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines apply and the tax per ton of coal is capped at 2 percent of the amount for which it is sold by the producer.

Effective date.–The proposal is effective for coal sales after December 31, 2004.

Analysis

Trust fund financing of benefits was established in 1977 to reduce reliance on the Treasury and to recover costs from the mining industry. Claims were much more numerous than expected and it was difficult to find responsible operators, litigate their challenges and collect from them. Therefore, deficits were financed with interest-bearing advances from the General Fund. During each year of the period 1992-2002, the expenses of the program covered by the trust fund (benefits, administration and interest) have exceeded revenues, with an advance from the General Fund making up the difference and accumulating as a debt.[514] Direct costs (benefits and administration), however, have been less than revenues. According to the Congressional Research Service, if it were not for the interest on the accumulated deficit, the trust fund would

[514] Congressional Research Service, RS21239 *The Black Lung Benefits Program* (June 12, 2002) at 6.

be self-supporting: "In effect, the annual advances from the Treasury are being used to pay back interest to the Treasury, while the debt has been growing as if with compound interest."[515]

Miners and survivors qualify for benefits from the Fund only if the miner's mine employment terminated before 1970 or no mine operator is liable for the payment of benefits. Some might argue that since the Federal Government has essentially made a loan to itself with a transfer between funds, the interest component should be forgiven. Because the class of beneficiaries is dwindling and revenues currently cover benefits and administrative costs, coal tax revenues could eventually pay off the bonds if extended at their current rates.

Based on historical trends, it appears that the trust fund will not be able to pay off its debt by December 31, 2013. Therefore, it could be argued that it is appropriate to continue the tax on coal at the increased rates beyond that expiration date until the debt is repaid, rather than require that the General Fund provide even larger advances to the trust fund. On the other hand, since the tax is not scheduled to be reduced until December 31, 2013, it could be argued that this proposal to further extend the rates is premature.

Prior Action

An identical proposal was included in the President's fiscal year 2005 budget proposal.

[515] Id.

IX. OTHER PROVISIONS MODIFYING THE INTERNAL REVENUE CODE

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

Present Law

Child Credit

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

Earned Income Credit

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

Effective date.–The proposal would be effective upon enactment.

Description of Proposal

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

Analysis

The exclusion of combat pay from gross income is intended to benefit military personnel serving in combat. However, to the extent that certain tax benefits, such as the child credit and the earned income credit, may vary based on taxable or earned income, the exclusion has the potential to increase tax liability. Including combat pay in gross income for purposes of the refundable child credit is always advantageous to the taxpayer. However, including combat pay for purposes of calculating the earned income credit may either help or hurt the taxpayer, because the credit both phases in and phases out based on earned income.[516]

If the objective of the present-law rules it to ensure that the exclusion of combat pay from gross income does not result in an increase in tax liability, an election to include combat pay in income for all Code purposes would be sufficient to achieve that objective. Present law, however, takes a more taxpayer favorable approach by allowing the tax treatment of combat pay

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

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

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

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

Prior Action

No prior action.

B. Expand Protection for Members of the Armed Forces

Present Law

General time limits for filing tax returns

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. This suspension of the time period rules also applies to persons deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a contingency operation or that becomes a contingency operation. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified

hospitalization resulting from injury received in the combat zone[517] or (2) time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts:

1. Filing any return of income, estate, or gift tax (except employment and withholding taxes);

2. Payment of any income, estate, or gift tax (except employment and withholding taxes);

3. Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

4. Allowance of a credit or refund of any tax;

5. Filing a claim for credit or refund of any tax;

6. Bringing suit upon any such claim for credit or refund;

7. Assessment of any tax;

8. Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

9. Collection of the amount of any liability in respect of any tax;

10. Bringing suit by the United States in respect of any liability in respect of any tax; and

11. Any other act required or permitted under the internal revenue laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

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[517] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

Servicemembers Civil Relief Act

In general, section 510 of the Servicemembers Civil Relief Act[518] provides that if a servicemember's ability to pay Federal or State income tax liability falling due before or during military service is materially affected by military service (whether or not in a combat zone), collection activities with respect to the tax liability is deferred for the period of military service and up to 180 days after the servicemember's termination or release from military service. No interest or penalties accrue on the unpaid income tax liability during the period of deferment. The statute of limitations for the collection of the taxes affected by the deferral is also extended. The deferral does not apply to certain Social Security taxes.

Description of Proposal

The proposal makes the provisions of section 7508 that are currently available to members of the Armed Forces in combat zones or contingency operations applicable to all Armed Forces reservists and National Guardsmen called to active duty (regardless of the location of their active duty). Active duty for persons in the National Guard is defined as being called to active duty by the President or the Secretary of Defense for a period of more than 30 consecutive days under section 502(f) of Title 32, United States Code. Accordingly, calls to active duty by a Governor are ineligible for this expanded provision. Parallel rules apply to Armed Forces reservists. In addition, training duty is not considered to be active duty for this purpose.

The proposal extends Section 510 of the Servicemembers Civil Relief Act to suspend the assessment and collection of any state income tax liability for all servicemembers (including Armed Forces reservists and National Guardsmen) serving in a designated combat zone and for all other Armed Forces reservists and National Guardsmen called to active duty.

Effective date.–The proposal would be effective upon enactment.

Analysis

One issue is whether it is appropriate to extend these benefits to all reservists on active duty (regardless of the location of their active duty) who may be stationed alongside regular servicemembers who, if not stationed in a combat zone, do not enjoy these benefits.

The proposal increases administrative complexity for the Internal Revenue Service. For example, eligibility for the benefits is dependent upon whether the call to active duty is issued by the Federal government or a State government. Particularly in cases where the servicemember's ability to pay is not materially affected, it is unclear whether this administrative complexity is warranted.

Prior Action

An identical proposal was included in the President's fiscal year 2005 budget proposal.

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[518] Pub. L. No. 108-189, (2003).

C. Extension of the Rate of Rum Excise Tax Cover Over to Puerto Rico and Virgin Islands

Present Law

A $13.50 per proof gallon[519] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[520] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[521]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[522] The amount of the cover over is limited under Code section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2005).[523]

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[524] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[525] All of the amounts covered over are subject to the limitation.

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[519] A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

[520] Sec. 5001(a)(1).

[521] Secs. 5062(b), 7653(b) and (c).

[522] Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

[523] The amount covered over is limited to the amount of excise tax imposed under section 5001(a)(1), if lower than the limits stated above. Sec. 7652(f)(2).

[524] Sec. 7652(e)(2).

[525] Secs. 7652(a)(3), (b)(3), and (e)(1).

Description of Proposal

The proposal extends the $13.25-per-proof-gallon cover over rate for one additional year, through December 31, 2006.

Effective date.–The proposal is effective for articles brought into the United States after December 31, 2005.

Analysis

The fiscal needs of Puerto Rico and the Virgin Islands were the impetus to extend the increased cover over rate to bolster the Treasuries in those possessions. Rather than rely on rum consumption in the United States, increased revenue could be achieved by intergovernmental support through a direct appropriation. The advantage of a direct appropriation is that it provides for annual oversight. Some might argue that a cover over is akin to an entitlement in terms of the annual budget process and making it permanent ensures a steady flow of revenue. Although the cover over may provide a more stable revenue stream, it may be more difficult to administer than a direct appropriation.

Prior Action

The $13.25 per-proof-gallon cover over rate had been scheduled to expire after December 31, 2003. The President's fiscal year 2004 and 2005 budget proposals included a proposal that extended the $13.25 per-proof-gallon cover over rate for two additional years, through December 31, 2005. The Working Families Tax Relief Act of 2004 enacted that proposal into law.[526]

[526] Pub. L. No. 108-311, sec. 305 (2004).

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL

Fiscal Years 2005 - 2015

[Millions of Dollars]

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2005-10	2005-15
I. Making Permanent Certain Tax Cuts Enacted in 2001 and 2003:														
A. Extend the 15%/0% Dividends Rate Structure Beginning in 2009	tyba 12/31/08	---	---	---	-854	-4,363	-8,609	-13,160	-14,638	-16,292	-17,490	-18,759	-13,825	-94,165
B. Extend the 15%/0% Capital Gains Tax Rate Structure Beginning in 2009	tyba 12/31/08	---	---	---	-1,549	-8,375	984	-8,663	-8,596	-8,857	-9,129	-9,432	-8,940	-53,617
C. Increase Section 179 Expensing From $25,000 to $100,000 and Increase the Phaseout Threshold Amount From $200,000 to $400,000; Include Software in Section 179 Property; and Extend Indexing of Both the Deduction Limit and the Phaseout Threshold	tyba 12/31/07	---	---	---	-2,605	-4,459	-3,221	-2,449	-1,953	-1,609	-1,431	-1,385	-10,286	-19,113
D. Reductions in Individual Income Tax Rates	tyba 12/31/10	---	---	---	---	---	---	-83,935	-125,791	-129,306	-133,046	-137,490	---	-609,568
E. Child Tax Credit	tyba 12/31/10	---	---	---	---	---	---	-6,797	-34,073	-34,510	-34,989	-35,500	---	-145,869
F. Marriage Penalty Relief	tyba 12/31/10	---	---	---	---	---	---	-5,321	-9,916	-9,443	-8,932	-8,334	---	-41,947
G. Education Incentives	generally 1/1/11	---	---	---	---	---	---	-1,510	-2,546	-2,810	-3,085	-3,249	---	-13,199
H. Repeal of Estate and Generation-Skipping Transfer Taxes, and Modification of Gift Taxes	dda & gma 12/31/10	---	-1,135	-1,591	-1,999	-1,785	-2,556	-28,300	-54,883	-59,269	-66,730	-71,645	-9,065	-289,893
I. Modifications of IRAs and Pension Plans	generally 1/1/11	---	---	---	---	---	---	-1,752	-3,339	-3,992	-4,674	-5,232	---	-18,989
J. Other Incentives for Families and Children [1]	generally 1/1/11	---	---	---	---	---	---	-332	-1,050	-1,102	-1,130	-1,174	---	-4,787
Total of Making Permanent Certain Tax Cuts Enacted in 2001 and 2003		**---**	**-1,135**	**-1,591**	**-7,007**	**-18,982**	**-13,402**	**-152,219**	**-256,785**	**-267,190**	**-280,636**	**-292,200**	**-42,116**	**-1,291,147**
II. Tax Incentives														
A. Provisions Related to Savings														
1. Expansion of tax-free savings opportunities	1/1/06	---	2,793	4,893	4,135	2,501	237	-1,614	-2,542	-3,415	-4,268	-5,156	14,560	-2,437
2. Consolidation of employer-based savings accounts [2]	yba 12/31/05	---	-187	-243	-246	-257	-277	-300	-333	-356	-375	-394	-1,210	-2,968
3. Individual development accounts ("IDAs")	[3]	---	---	-150	-306	-319	-318	-294	-264	-232	-107	[4]	-1,093	-1,991
B. Health Care Provisions														
1. Refundable tax credit for the purchase of health insurance [5]	tyba 12/31/05	---	-67	-7,529	-7,434	-7,176	-7,249	-7,258	-7,078	-6,927	-6,809	-6,653	-29,455	-64,180
2. Provide an above-the-line deduction for certain high deductible insurance premiums [6]	tyba 12/31/05	---	-101	-2,161	-2,409	-2,717	-3,071	-3,481	-4,100	-4,498	-4,924	-5,329	-10,458	-32,791
3. Provide a refundable tax credit for contributions of small employers to employee HSAs [6]	tyba 12/31/05	---	-167	-586	-1,006	-1,421	-1,831	-2,243	-2,653	-3,067	-3,484	-3,905	-5,011	-20,362
4. Modify the refundable credit for health insurance costs of eligible individuals	tyba 12/31/05	---	-14	-18	-18	-19	-19	-20	-20	-21	-22	-21	-88	-192
5. Expand human clinical trial expenses qualifying for the orphan drug tax credit	qeia 12/31/04	[7]	-2	-2	-3	-3	-3	-4	-4	-4	-5	-5	-14	-35

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2005-10	2005-15
C. Provisions Relating to Charitable Giving														
1. Permit tax-free withdrawals from IRAs for charitable contributions	da DOE	-97	-346	-294	-284	-287	-298	-299	-312	-313	-315	-321	-1,606	-3,165
2. Expand and increase the enhanced charitable deduction for contributions of food inventory	tyba 12/31/04	-89	-177	-181	-185	-189	-193	-197	-202	-206	-211	-215	-1,014	-2,045
3. Reform excise tax based on investment income of private foundations	tyba 12/31/04	-35	-121	-91	-96	-101	-104	-108	-111	-116	-121	-126	-550	-1,131
4. Modify tax on unrelated business taxable income of charitable remainder trusts	tyba 12/31/04	-5	-5	-6	-6	-6	-7	-7	-7	-8	-8	-8	-35	-73
5. Modify the basis adjustment to stock of S corporations contributing appreciated property	tyba 12/31/04	-15	-32	-36	-40	-47	-55	-60	-66	-72	-78	-84	-225	-585
6. Repeal the $150 million limit for qualified 501(c)(3) bonds	bia DOE	-8	-20	-22	-16	-12	-10	-9	-9	-9	-9	-9	-88	-133
7. Repeal restrictions on the use of qualified 501(c)(3) bonds for residential rental property	bia DOE	-1	-4	-9	-14	-20	-26	-32	-38	-44	-51	-57	-74	-296
D. Extend, Increase, and Expand the Above-the-Line Deduction for Qualified Out-of-Pocket Classroom Expenses	eii tyba 12/31/05	---	-44	-294	-302	-312	-321	-336	-374	-386	-397	-409	-1,272	-3,175
E. Exclude from Income of Individuals the Value of Employer-Provided Computers, Software and Peripherals	tyba 12/31/05	---	-23	-34	-36	-39	-41	-43	-45	-46	-48	-51	-173	-407
F. Establish Opportunity Zones	tyba 12/31/05	---	-398	-926	-877	-873	-844	-872	-956	-1,048	-1,140	-1,225	-3,918	-9,158
G. Provide Tax Relief for Federal Emergency Management Agency ("FEMA") Hazard Mitigation Assistance Programs	mara 12/31/04	---	-6	-7	-6	-8	-10	-12	-14	-15	-16	-16	-36	-109
H. Provide a Tax Credit for Developers of Affordable Single-Family Housing	fyca cy06	---	-9	-93	-328	-751	-1,320	-1,965	-2,565	-3,020	-3,293	-3,440	-2,501	-16,784
I. Environment and Conservation Related Provisions														
1. Permanently extend expensing of "brownfields" remediation costs	po/a 1/1/06	4	-166	-275	-264	-250	-234	-219	-207	-195	-187	-180	-1,185	-2,172
2. Exclude 50% of gains from the sale of property for conservation purposes (sunset 12/31/08)	so/a 1/1/06	-2	-60	-90	-102	-95	-37	---	---	---	---	---	-386	-386
J. Energy Provisions														
1. Extend and modify the tax credit for producing electricity from certain sources (sunset 12/31/08)	[8]	---	-49	-149	-257	-268	-254	-254	-249	-248	-252	-254	-978	-2,236
2. Provide a tax credit for residential solar energy systems	[9]	---	-18	-20	-24	-24	-24	---	---	---	---	---	-109	-109
3. Modify the tax treatment of nuclear decommissioning funds	tyba 12/31/04	-51	-196	-178	-201	-230	-253	-287	-295	-298	-288	-275	-1,109	-2,552
4. Provide a tax credit for purchase of certain hybrid (sunset 12/31/08) and fuel cell vehicles (sunset 12/31/12)	pqva 12/31/04	-2	-449	-463	-562	-530	-22	-20	-19	-20	-21	-21	-2,028	-2,129
5. Provide a tax credit for combined heat and power property	ppisa 12/31/04 & before 1/1/10	-63	-91	-80	-78	-85	-52	-30	-20	-10	-2	4	-448	-506
K. Restructure Assistance to New York	tyba 12/31/06 & DOE	161	344	-71	-149	-93	-220	-266	-261	-250	-238	-230	-28	-1,273
Total of Tax Incentive Provisions		**-203**	**385**	**-9,115**	**-11,114**	**-13,631**	**-16,856**	**-20,230**	**-22,744**	**-24,824**	**-26,669**	**-28,380**	**-50,532**	**-173,380**
III. Simplify the Tax Laws for Families														
A. Repeal Phase-Out for Adoption Provisions	tyba 12/31/05	---	-19	-64	-64	-64	-65	-64	-66	-67	-70	-72	-277	-615
B. Clarify Eligibility of Siblings and Other Family Members For Child-Related Tax Benefits [6]	tyba 12/31/04	6	109	112	114	117	119	122	124	127	130	133	577	1,213
Total of Simplify the Tax Laws for Families		**6**	**90**	**48**	**50**	**53**	**54**	**58**	**58**	**60**	**60**	**61**	**300**	**598**

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2005-10	2005-15
IV. Provisions Related to the Employer Based Pension System														
A. Provisions Relating to Cash Balance Plans	cma DOE & DOE	-4	-22	-26	-32	-35	-41	-32	7	53	78	73	-159	20
B. Strengthen Funding for Single-Employer Pension Plans [10]	generally pyba 12/31/05	---	303	1950	818	-4102	-5770	-4092	-1682	524	835	670	-6,801	-10,546
C. Reflect Market Interest Rates in Lump-Sum Payments	dmi pyba 12/31/06	---	---	-3	-6	-13	-14	-18	-19	-20	-20	-20	-36	-133
Total of Provisions Related to the Employer Based Pension System		**-4**	**281**	**1,921**	**780**	**-4,150**	**-5,825**	**-4,142**	**-1,694**	**557**	**893**	**723**	**-6,996**	**-10,659**
V. Tax Shelters, Abusive Transactions, and Tax Compliance														
A. Combat Abusive Foreign Tax Credit Transactions	teia DOE	1	5	5	5	5	5	5	5	5	5	5	26	51
B. Modify the Active Trade or Business Test For Certain Corporate Divisions	[11]	2	8	10	11	12	13	14	15	17	18	19	56	139
C. Impose Penalties on Charities that Fail to Enforce Conservation Easements [12]	tyba 12/31/04	1	5	5	5	5	5	5	5	5	5	5	26	51
D. Eliminate the Special Exclusion from Unrelated Business Taxable Income for Gain or Loss on Sale or Exchange of Certain Brownfield Properties	1/1/05	---	-1	-1	6	18	28	38	49	34	15	15	50	201
E. Apply an Excise Tax to Amounts Received Under Certain Life Insurance Contracts	ceia 2/7/05	1	4	9	14	19	25	31	37	44	51	59	72	295
F. Limit Related-Party Interest Deductions	dofca	2	105	196	266	296	330	336	343	351	361	370	1,195	2,956
G. Modify Certain Tax Rules for Qualified Tuition Programs	aea DOE	---	2	4	5	7	9	11	14	16	18	21	27	108
Total of Tax Shelters, Abusive Transactions, and Tax Compliance		**7**	**128**	**228**	**312**	**362**	**415**	**440**	**468**	**472**	**473**	**494**	**1,452**	**3,801**
VI. Tax Administration Provisions and Unemployment Insurance														
A. IRS Restructuring and Reform Act of 1998														
1. Modify section 1203 of the IRS Restructuring and Reform Act of 1998	DOE	*Negligible Revenue Effect*												
2. Modifications with respect to frivolous returns and submissions	smo/a DOE	[13]	3	3	3	3	3	3	3	3	3	3	15	30
3. Termination of installment agreements	foo/a DOE	*Negligible Revenue Effect*												
4. Consolidate review of collection due process cases in the Tax Court	adma DOE	*Negligible Revenue Effect*												
5. Office of Chief Counsel review of offers-in-compromise	oicsopo/a DOE	*No Revenue Effect*												
B. Initiate IRS Cost Saving Measures														
1. Allow the Financial Management Service to retain transaction fees from levied amounts [14]	DOE	*No Revenue Effect*												
2. Extend the due date for electronically filed tax returns and expand authority to require electronic filing by large businesses and exempt organizations	tyba 12/31/05	*No Revenue Effect*												
C. Other Provisions														
1. Allow IRS to access information in the National Directory of New Hires	DOE	*Negligible Revenue Effect*												
2. Extension of authority for undercover operations	prfuot 12/31/10	---	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[15]	[15]
D. Strengthen the Financial Integrity of Unemployment Insurance	---	*Estimate Will Be Provided by the Congressional Budget Office*												
Total of Tax Administration Provisions and Unemployment Insurance		**[13]**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**15**	**30**

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2005-10	2005-15
VII. Reauthorize Funding for the Highway Trust Fund														
A. Extend Excise Taxes Deposited in the Highway Trust Fund	10/1/05	*No Revenue Effect*												
B. Allow Tax-Exempt Financing for Private Highway Projects and Rail-Truck Transfer Facilities	bia DOE	-2	-12	-27	-44	-61	-79	-96	-114	-132	-150	-169	-225	-886
Total of Reauthorize Funding for the Highway Trust Fund		**-2**	**-12**	**-27**	**-44**	**-61**	**-79**	**-96**	**-114**	**-132**	**-150**	**-169**	**-225**	**-886**
VIII. Expiring Provisions														
A. Permanently Extend Research and Experimentation (R&E) Tax Credit	epoia 12/31/05	---	-2,280	-4,700	-6,083	-7,257	-8,227	-8,834	-9,317	-9,810	-10,318	-10,841	-28,547	-77,668
B. Permanently Extend and Expand Disclosure of Tax Return Information for Administration of Student Loans	Da DOE	*Estimate Will Be Provided by the Congressional Budget Office*												
C. Extend and Modify the Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit (through 12/31/05)	wpoifibwa 12/31/05 & before 1/1/07	---	-106	-174	-91	-41	-23	-13	-3	---	---	---	-435	-450
D. Extend the District of Columbia Homebuyer Tax Credit (through 12/31/06)	pma 12/31/05	---	-5	-12	---	---	---	---	---	---	---	---	-17	-17
E. Extend Authority to Issue Qualified Zone Academy Bonds (through 12/31/07)	bia 12/31/05	---	-2	-7	-15	-24	-31	-32	-32	-32	-32	-32	-79	-239
F. Extend Deduction for Corporate Donations of Computer Technology (through taxable years beginning before 12/31/06)	tyba 12/31/05	---	-66	-55	---	---	---	---	---	---	---	---	-121	-121
G. Extend Provisions Permitting Disclosure of Tax Information Relating to Terrorist Activity (through 12/31/06)	1/1/06	*No Revenue Effect*												
H. Extend excise taxes deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund (through 12/31/07)	4/1/05	*No Revenue Effect*												
I. Extend Excise Tax on Coal at Current Rates	csa 12/31/04	---	---	---	---	---	---	---	---	---	204	248	---	452
Total of Expiring Provisions		**---**	**-2,459**	**-4,948**	**-6,189**	**-7,322**	**-8,281**	**-8,879**	**-9,352**	**-9,842**	**-10,146**	**-10,625**	**-29,199**	**-78,043**
IX. Other Provisions Modifying the Internal Revenue Code														
A. Election to Treat Combat Pay as Earned Income for Purposes of EIC (through 12/31/06)	tyba 12/31/05 & tyeb 1/1/07	---	[4]	-14	---	---	---	---	---	---	---	---	-14	-14
B. Expand Protection for Members of the Armed Forces	DOE	-3	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-3	-3
C. Extension of the Rate of Rum Excise Tax Cover Over to Puerto Rico and Virgin Islands (through 12/31/06) [16]	abiUSa 12/31/05	-11	-58	-18	---	---	---	---	---	---	---	---	-87	-87
Total of Other Provisions Modifying the Internal Revenue Code		**-14**	**-58**	**-32**	**[4]**	**[4]**	**[4]**	**[4]**	**[4]**	**[4]**	**[4]**	**[4]**	**-104**	**-104**
NET TOTAL [17]		**-210**	**-2,777**	**-13,513**	**-23,209**	**-43,728**	**-43,971**	**-185,065**	**-290,160**	**-300,896**	**-316,172**	**-330,093**	**-127,405**	**-1,549,790**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is assumed to be July 1, 2005.

[Legend and Footnotes for the Table appear on the following page]

Legend and Footnotes for the Table:

Legend for "Effective" column:

abiUSa = articles brought into the United States after
adma = appeals determinations made after
aea = accounts established after
bia = bonds issued after
ca = collections after
ceia = contracts entered into after
cma = conversions made after
csa = coal sales after
cy = calendar year
da = distributions after
DA = disclosures after
dda = decedents dying after
dmi = distributions made in
DOE = date of enactment
dofca = date of first committee action
eii = expenses incurred in
epoia = expenses paid or incurred after
foo/a = failures occurring on or after
fyca = first-year calendar allocations
gma = gifts made after
mara = mitigation assistance received after
oicsopo/a = offers in compromise submitted or pending on or after
pma = payments made after
po/a = payments on or after
pqva = purchase of qualified vehicles after
prfuot = proceeds received from undercover operations through
pyba = plan years beginning after
qeia = qualified expenses incurred after
smo/a = submissions made on or after
so/a = sales on or after
teia = transaction entered into after
tyba = taxable years beginning after
tyeb = taxable years ending before
wpoifibwa = wages paid or incurred for individuals beginning work after
yba = years beginning after

[1] Extension of the adoption tax credit, employer-provided child care tax credit, and dependent care tax credit.
[2] Estimate includes interaction effect with proposal to expand tax-free savings opportunities under Title II.
[3] The credit would apply with respect to the first 900,000 IDA accounts opened after December 31, 2006, and before January 1, 2012, and with respect to matching funds for participant contributions that are made after December 31, 2006, and before January 1, 2014.
[4] Loss of less than $500,000.
[5] Estimate does not include the effects of the State option to allow use of the credit to buy into privately-contracted State-sponsored purchasing groups.
[6] Estimate is preliminary and subject to change.
[7] Loss of less than $1 million.
[8] For wind, closed-loop biomass, open-loop biomass, and landfill gas facilities, effective for facilities placed-in-service after December 31, 2005, and before January 1, 2009.
[9] The credit would apply only to solar water heating equipment placed in service after December 31, 2004, and before January 1, 2008, and to photovoltaic systems placed in service after December 31, 2004, and before January 1, 2010.
[10] Revenue estimate does not include effects on PBGC premiums, which are offsetting receipts. The effects on PBGC premiums will be provided by Congressional Budget Office.
[11] No effective date for the proposal was provided by the Administration. For purposes of the revenue estimate, an effective date of distributions on or after the date of enactment is assumed.
[12] Proposal not fully specified; estimate is preliminary and subject to change.
[13] Gain of less than $500,000.
[14] Estimate provided by the Congressional Budget Office.
[15] Gain of less than $1 million.
[16] Preliminary outlay estimate provided by the Congressional Budget Office and is subject to change.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2005-10	2005-15
[17] Includes the following outlay effects	-5	-77	6,586	6,576	6,477	6,609	6,571	21,918	21,963	21,985	21,764	26,165	120,363