[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

PART ONE: INDIVIDUAL INCOME TAX AND ESTATE AND GIFT TAX PROVISIONS

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 2009

U.S. Government Printing Office
Washington: 2009

JCS-2-09

JOINT COMMITTEE ON TAXATION

111TH CONGRESS, 1ST SESSION

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CONTENTS

Page

INTRODUCTION 1

I. PERMANENT INDIVIDUAL ALTERNATIVE MINIMUM TAX RELIEF 2

II. MAKE PERMANENT CERTAIN TAX CUTS ENACTED IN 2001 AND 2003 8

A. Dividends and Capital Gains Tax Rate Structure 8
B. Marginal Individual Income Tax Rate Reductions 22
C. Child Tax Credit 27
D. Marriage Penalty Relief and Earned Income Tax Credit Simplification 29
E. Education Incentives 33
F. Modify and Make Permanent the Estate, Gift, and Generation Skipping Transfer Taxes After 2009 42
G. Other Incentives for Families and Children (includes extension of the adoption tax credit, employer-provided child care tax credit, and dependent care tax credit) 66
H. Reinstate the Personal Exemption Phase-out and Limitation on Itemized Deductions 70

III. TAX CUTS FOR FAMILIES AND INDIVIDUALS 74

A. Provide Making Work Pay Tax Credit 74
B. Increase in the Earned Income Tax Credit 78
C. Increase of Refundable Portion of the Child Credit 82
D. Saver's Credit 84
E. Automatic Enrollment in Individual Retirement Arrangements 88
F. Provide the American Opportunity Tax Credit 104

IV. REVENUE RAISING PROVISIONS 110

A. Income of Partners for Performing Services Treated as Ordinary Income 110
B. Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability 123
C. Eliminate Advance Earned Income Tax Credit 131

V. ESTATE AND GIFT TAX REFORM PROVISIONS 133

A. Require Consistency in Value for Transfer and Income Tax Purposes 133
B. Modify Rules on Transfer Tax Valuation Discounts 137
C. Require Minimum Term for Grantor Retained Annuity Trusts (GRATs) 146

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the individual income tax and estate and gift tax provisions that are included in the President's fiscal year 2010 budget proposal, as submitted to the Congress on May 7, 2009.[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), a reference to relevant prior budget proposals or recent significant legislative action, and an analysis of policy issues related to the proposal.

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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 2010 Budget Proposal; Part One: Individual Income Tax and Estate and Gift Tax Provisions* (JCS-2-09), September 2009.

The staff of the Joint Committee on Taxation has provided estimates of the revenue effects of each of the provisions described herein. See, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009*, (JCX-28-09), June 11, 2009.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010: Analytical Perspectives* (H. Doc. 111-3, Vol. III), at 253-267.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009.

I. PERMANENT INDIVIDUAL ALTERNATIVE MINIMUM TAX RELIEF

Present Law

In general

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

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

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

With certain exceptions discussed below, nonrefundable credits may not reduce an individual's tax liability to less than the tentative minimum tax liability.

Preference items in computing alternative minimum taxable income

The minimum tax preference items are:

1. The excess of the deduction for percentage depletion over the adjusted basis of mineral property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

2. The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to independent producers to the extent the producer's AMTI is reduced by 40 percent or less by ignoring the preference.

3. Tax-exempt interest income on private activity bonds issued after August 7, 1986. The preference does not apply to qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010.

4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

5. Seven percent of the amount excluded from income under section 1202[4] (relating to gains on the sale of certain small business stock).[5]

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.[6]

Adjustments in computing alternative minimum taxable income

The adjustments that individuals must make to compute AMTI are:

1. Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

2. Mining exploration and development costs must be capitalized and amortized over a 10-year period.

3. Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

4. The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

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[4] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[5] After 2010, the 7-percent amount increases to 28 and 42 percent, depending when the stock was acquired.

[6] Given the passage of section 469 by the Tax Reform Act of 1986 (relating to the deductibility of losses from passive activities), these provisions have little application (i.e., are "deadwood").

5. Miscellaneous itemized deductions are not allowed.

6. Deductions for State, local, and foreign real property taxes; State and local personal property taxes; State, local, and foreign income, war profits, and excess profits taxes; and State and local sales taxes are not allowed.

7. Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income.

8. The standard deduction (other than the portion of the standard deduction relating to disaster losses and qualified motor vehicle taxes) and the deduction for personal exemptions are not allowed.

9. The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a three-year period.

10. The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a ten-year period.[7]

11. The special regular tax rules relating to incentive stock options do not apply.

12. The net operating loss deduction cannot reduce the taxpayer's AMTI by more than 90 percent of the AMTI determined without regard to the deduction.

Treatment of credit

Personal credits

Present law provides for certain nonrefundable personal tax credits.[8] For taxable years beginning before 2010, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and AMT.

For taxable years beginning after 2009, certain of the nonrefundable personal credits[9] are allowed only to the extent that the individual's regular income tax liability exceeds the

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[7] No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

[8] These credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit.

[9] These credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit (after 2010), the child credit (after 2010), the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits (with a special rule for 2010), the credit for certain nonbusiness energy property, and the D.C. first-time homebuyer credit.

individual's tentative minimum tax, determined without regard to the AMT foreign tax credit. The remaining nonrefundable personal credits are allowed to the full extent of the individual's regular tax and AMT.

Minimum tax credit

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year. For individuals, the credit is allowed only to the extent that the taxpayer's AMT liability is the result of adjustments that are timing in nature. The individual AMT adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items. Special rules apply to individuals with long-term unused minimum tax credits.

General business credit

The general business credit, with certain exceptions, is generally allowed only to the extent the taxpayer's regular tax liability exceeds the tentative minimum tax.

Foreign tax credit

The tentative minimum tax is reduced by the AMT foreign tax credit. This credit is determined using AMTI and the tentative minimum tax rather than taxable income and the regular tax.

Description of Proposal

Under the proposal, the exemption amounts in effect for 2009 are made permanent and the exemption amounts (including the beginning amounts for the phase-outs) are indexed for inflation. The breakpoint between the 26- and 28-percent brackets also is indexed for inflation.

Under the proposal, the nonrefundable personal credits are allowed to the full extent of the individual's regular tax and AMT.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2009.

Analysis

The original minimum tax provision was enacted to limit the amount of income which an individual could exclude from tax as the result of various tax preferences, and thus insure that individuals pay significant amounts of tax on their economic income.[10] The minimum tax has

[10] Staff of the Joint Committee on Internal Revenue Taxation, *General Explanation of the Tax Reform Act of 1969,* p. 105 (December 3, 1970).

been substantially revised since its original enactment and today the tax no longer limits most tax preferences. Instead the principal effect of the current tax is to limit the deduction for State and local taxes, miscellaneous itemized deductions, the deduction for personal exemptions, the standard deduction, and certain nonrefundable tax credits.

The individual AMT is in some sense a separate tax system within the individual income tax system that applies a more compressed rate structure to a broader base of income. The AMT requires a calculation of a second income tax base and computation of a tax on that base, so the present tax system, with an AMT, is not as simple to administer or comply with as would be the same system without an AMT. Though relatively few taxpayers currently are subject to the AMT, many taxpayers must undertake the AMT calculation to determine whether, in fact, they are liable or whether the utilization of certain credits is limited. Also, absent changes to the AMT, many more individuals will become affected by the AMT in the future.

The AMT raises particular equity issues with respect to preference items that are personal in nature. For example, some believe that it is fair that families with many dependents pay less tax than families with fewer dependents and support the regular-tax allowance of personal exemptions and child credits to further this goal. Additionally, many believe that the regular tax permits a deduction for State and local taxes because such payments impact ability to pay Federal income tax, and therefore they believe a similar deduction for AMT purposes should be allowed.[11] The AMT, in disallowing these exemptions, deductions, and credits, may frustrate this view of fairness. Also, under present law, as a result of the lack of indexing the AMT exemption levels, the reach of the AMT will increasingly extend further down the income distribution and thus make the tax system less progressive.[12]

By indexing the exemption levels and the bracket break points under the AMT, the Administration proposal would maintain the current relationship between the regular tax and the tentative minimum tax, thus preventing additional individuals from being subject to the AMT by reason of inflation. By limiting the increase in the number of individuals subject to the AMT, the tax code will be simpler than it otherwise would have been. Additionally, by preventing the AMT from extending further down the income distribution, the tax system will retain its current level of progressivity from the AMT, rather than grow less progressive as a result of the current lack of indexation of the AMT.

The AMT, as presently constituted, has few defenders. Hence, critics of the Administration proposal would generally not oppose the general thrust of the Administration proposal, but rather argue that the proposal simply does not go far enough and eliminate the AMT altogether. Proponents of eliminating the AMT note that all of the arguments in favor of restricting the reach of the AMT are also applicable to its elimination.

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[11] Others believe that the deduction for State and local taxes should not be permitted under either the regular tax or the AMT, as they believe such a deduction subsidizes public expenditure at the State and local level.

[12] In the past, Congress has enacted numerous temporary increases of the exemption amounts. The latest increase was enacted for 2009 by the American Recovery and Reinvestment Tax Act of 2009 ("ARRA"), Pub. L. No. 111-5.

Prior Action

The increased exemption amount for 2009 was adopted by the American Recovery and Reinvestment Tax Act of 2009.

II. MAKE PERMANENT CERTAIN TAX CUTS ENACTED IN 2001 AND 2003

A. Dividends and Capital Gains Tax Rate Structure

Present Law

Dividends

In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax rates before 2011

Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains. This treatment applies for purposes of both the regular tax and the AMT. Thus, for taxable years beginning before 2011, dividends received by an individual are taxed at rates of zero and 15 percent.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Qualified dividend income includes otherwise qualified dividends received from a qualified foreign corporation. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (1) the qualified dividend income of the RIC for the taxable year and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.[13]

Tax rates after 2010

For taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income tax rates.

Capital gains

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

[13] In addition, for taxable years beginning before 2011, amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

<u>Tax rates before 2011</u>

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

Tax rates after 2010

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital gain rate is taxed at an 8-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, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2011.

Description of Proposal

Under the proposal, the tax rates in effect before 2011 are made permanent. In addition, a 20-percent rate will apply to adjusted net capital gain and qualified dividend income that otherwise would be taxed at the two highest rates under the regular tax.

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

Analysis

Dividends

Under present law, the United States has a "classical" system of taxing corporate income. Under this system, corporations and their shareholders are treated as separate persons. A tax is imposed on the corporation on its taxable income, and after-tax earnings distributed to individual shareholders as dividends are included in the individual's income and taxed at the individual's tax rate. This system creates the so-called "double taxation of dividends." Prior to 2003, corporate dividends received by an individual taxpayer were taxed at the same rate as ordinary income. By reducing the tax rate applicable to dividends in 2003, the Congress hoped to mitigate the double taxation of dividends and the implicit bias in favor of returns received from ownership of corporate equity in the form of capital gains. This was intended to reduce economic distortions.

The classical system, it is argued, results in economic distortions. Economically, the issue is not that dividends are taxed twice, but rather the total tax burden on income from different investments. Business investments in entities not subject to corporate tax, such as partnerships, limited liability companies, and S corporations generally are taxed more favorably. An investment in a C corporation that returned $100 would pay a $35 corporate income tax and

then, if the remaining $65 were paid out as a dividend to a shareholder in the highest individual income tax bracket (presently 35 percent), the shareholder would net $42.25. Had the investment been made through a partnership, the taxpayer would have received $65 ($100 - ($100 multiplied by 35 percent)) after tax. Thus, analysts observe that because a classical system creates different after-tax returns to investments undertaken in different legal forms that the choice of legal entity is distorted and economic efficiency is reduced.

Critics of a classical system argue that a classical system distorts corporate financial decisions. They argue that because interest payments on the debt are deductible, while dividends are taxable, a classical system encourages corporations to finance using debt rather than equity. They observe that the increase in corporate leverage, while beneficial to each corporation, may place the economy at risk to more bankruptcies during an economic downturn.

Similarly a classical system encourages corporations to retain earnings rather than to distribute them as taxable dividends. Drawing on the example above, if the corporation had retained the $65 of income net of the corporate income tax, the value of the corporation should increase by $65. If shareholders sold their shares, under present law they would recognize the $65 as a capital gain and generally incur a $9.75 income tax liability. Thus, a retention policy could result in net income to the shareholder of $55.25 as opposed to $42.25 if income were paid out as a dividend.[14] This difference in effective tax burden may mean that shareholders prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings. This is another source of inefficiency as the opportunity to earn higher pre-tax returns is passed up in favor of lower pre-tax returns. The present-law reduced rate of tax on qualified corporate dividends narrows the difference in effective tax burden between a policy of dividends and a policy of retaining earnings.

Proponents of the reduced rates of tax on dividend income under present law observe that by reducing the aggregate tax burden on investments made by corporations, the proposal would lower the cost of capital needed to finance new investments and may increase investment in the aggregate as well as investment by C corporations. Increased investment ultimately should lead to increased labor productivity, higher real wages, and increased long-term economic growth. However, there is no consensus about the magnitude of the long-run responsiveness of investment to changes in the cost of capital.

The simple examples used above to illustrate potential sources of economic inefficiency in a classical system may overstate the aggregate tax burden on investments made by C corporations. Critics of present law have questioned whether there is a substantial effect on corporate investment because persons not subject to the individual income tax (e.g., foreign persons and tax-exempt institutions such as pension funds) hold substantial amounts of corporate equity. If these shareholders are the providers of incremental investment funds, present law generally does not change the aggregate tax burden on an investment made by a C corporation.

[14] In practice the effective tax rate difference between the dividend policy and retention policy would be greater. This simple example assumes the capital gain is recognized immediately. Taxpayers can choose to defer recognition of gain. By deferring gain, the effective tax burden on the gain declines.

Critics of present law also observe that, in the early years, much of the tax reduction from reduced taxes on dividend income accrues to returns to investments made by C corporations in the past and not new investment. Moreover, critics observe that, as corporate stock when held by individuals outside of tax-favored retirement accounts is generally held more extensively by taxpayers above the median income, the benefit of the present-law reduced rates of tax most directly benefits higher-income taxpayers.

Capital gains

Both present law and the Administration's proposal would provide for a maximum tax rate on income from realized capital gains that is less than the tax rate applicable to a taxpayer's income from labor income (wages and salary) and from other types of capital income (e.g., interest, dividends, and rental income). The differential in tax rates between income from realized capital gains and other sources of income raises several policy issues.

- Does a differential rate promote improved efficiency of the capital markets?
- Does a differential rate promote the socially optimal level of risk taking?
- Does a differential rate promote long-run economic growth?
- Is income from capital gains properly measured?
- Is a differential in rates consistent with policy makers' equity goals?

Does a differential rate promote improved efficiency of the capital markets?

Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this "lock-in effect" is exacerbated by the rules that allow a step-up in basis at death and defer or exempt certain gains on sales of homes. As an example of what is meant by the lock-in effect, suppose a taxpayer paid $500 for a stock that now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 20-percent tax rate, if the taxpayer sells the stock one year or more from now (when it is worth $1,100), he or she will net $980 after payment of $120 tax on the gain of $600. With a tax rate on gain of 20 percent, if the taxpayer sold this stock today, he or she would have, after tax of $100 on the gain of $500, $900 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.1 percent. With a tax rate on gain of 28 percent, the alternative investment would need to earn a total pre-tax return in excess of 11.6 percent to justify a switch, while the required rate of return with a 15-percent tax rate is only 10.8 percent. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. When the tax imposed on removing monies from old investments is reduced, taxpayers would not necessarily redirect their funds to new investments when their monies in older investments are unlocked. Taxpayers might instead choose to consume the proceeds. Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock-in.

To the extent that preferential rates may encourage investments in stock, and more specifically stock that offers its return in the form of capital gain rather than dividends, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Non-neutral treatment generally is not consistent with capital market efficiency. On the other hand, it is argued that asset neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Does a differential rate promote the socially optimal level of risk taking?

Some maintain that a preferential capital gains tax rate encourages investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. In theory, when a tax system accords full offset for capital losses, a reduction in tax rates applicable to capital gains would reduce risk taking. This is because with full loss offset the government acts like a partner in the investment, bearing an equal share of the risk, both good and bad. The reduction in tax rates reduces the government's share in gains and losses such that less risk is necessary to generate the same amount of after-tax income and the investor bears more of any loss.[15] However, the present-law limitation on taxpayers' ability to offset capital losses against other income creates a bias against risk taking by implicitly reducing the value of any loss by deferring its inclusion in income. A reduction in the tax rate on realized gain, proponents argue, therefore should increase risk taking. Proponents argue that the preference provides an incentive for investment and capital formation, with particular importance for venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate, broadly applied, is not targeted toward any particular type of equity investment. They note that a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments. They observe that present-law section 1202 (that provides certain small businesses with a reduced tax on realized capital gains) and present-law section 1244 (that provides expanded loss offset for investments in certain small business stock) more specifically target risk-taking activities.

The Administration's budget proposal also would expand the tax benefit under section 1202 by creating a tax rate of zero for qualified investments.[16] Proponents aver that it is important to provide a preference to equity investments in small businesses as they create the industries of the future. Opponents of such a capital gains preference point out that a tax preference could have only a small incentive effect on investment because a large source of venture capital and other equity investment is tax-exempt or partially tax-exempt entities (for

[15] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," *Quarterly Journal of Economics*, 58, May 1944.

[16] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010, Analytical Perspectives* (H. Doc. 111-3, Vol. III), at 267.

example, pension funds and certain insurance companies and foreign investors). For example, in 2008, tax-exempt entities (including public pension funds, endowments, foundations, sovereign wealth funds, and union pension funds) contributed nearly 44 percent of new venture capital funds.[17] On the other hand, proponents argue that preferential capital gains treatment for venture capitalists who are taxable is important. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital. They further observe that initial investors in new ventures are frequently friends and family of the entrepreneur, all of whom are taxable. The organized venture capitalists are more prevalent at later stages of financing. They observe that small businesses face a higher cost of capital than do larger, established businesses. However, a higher cost of capital does not necessarily indicate a market failure for which a tax subsidy might be justified. Small businesses are inherently risky. The majority of small businesses do not survive their first year. A higher cost of capital may only reflect market realities in assuming risk by investors and not a flaw in the capital markets. Others note that the Federal government has developed loan programs administered through the Small Business Administration to address the higher cost of capital faced by many small businesses. Proponents of a reduced capital gains tax rate on equity investments in small businesses argue that unlike the programs of the Small Business Administration, the proposed tax benefit is not limited by the appropriations process and is open to all businesses that meet the qualifying standards. They note that the market would still remain the judge of where to allocate investments among qualifying small businesses.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program. On the other hand, the capital gains preference may make equity more attractive than debt, the returns on which are taxed at ordinary income tax rates.

Does a differential rate promote long-run economic growth?

The United States has a low rate of household saving, averaging less than five percent of disposable income for more than the past decade.[18] This rate is low both in comparison to other industrialized countries and in comparison to prior United States experience. At the aggregate level, a low saving rate is a concern because saving provides the wherewithal for investment in productivity-enhancing equipment and technology. At the household level, a low saving rate may imply households are accumulating insufficient assets for retirement, emergencies, or other uses. By reducing the tax on realized capital gains, the after-tax return to household saving is increased.

[17] Dow Jones Private Equity Analyst, Sources of Capital, 2009, at 4, available at http://www.fis.dowjones.com/products/privateequityanalyst.html

[18] Council of Economic Advisers, *Economic Report of the President*, (Washington, D.C.: U.S. Government Printing Office), January 2009, at 320.

Theoretically, the effect on saving of a reduction of taxes on capital income is ambiguous. There are two effects. First, the increased return to saving should encourage people to save more. Second, the increased return people receive on assets they have already accumulated and on saving they had already planned increases their income. This increased income may encourage them to increase their consumption and may reduce their saving. Empirical economic evidence also is ambiguous on whether, or if at all, household saving responds to changes in the after-tax rate of return.

In addition, reduction in only the tax applicable to capital gains may prove to be an inefficient saving incentive. By favoring certain types of assets (those that generate returns in the form of accrued gains) over other types of assets (those that generate returns in the form of interest, dividends, or royalties), taxpayers may reallocate their holdings of assets to obtain higher after-tax returns without saving new funds. Such portfolio reallocations also represent reduced efficiency of capital markets as choices have been distorted. As noted above, the application of a reduced tax on capital gains to those who currently hold assets with accrued gains could lead to reduced saving as households sell those assets and increase consumption from the proceeds.

Is income from capital gains properly measured?

Some proponents of lower tax rates on income from capital gain observe that the preference may provide taxpayers some rough compensation for inflation. Part of the gain represents the effects of inflation and does not constitute real income.

Others note that a preferential tax rate is a very crude adjustment for inflation. In addition, as income taxed upon realization, generally at the taxpayer's discretion, a taxpayer realizing income from a capital gain enjoys a tax benefit from the deferral of tax on accrued appreciation until the asset is sold. The following example illustrates the benefit of deferral. Assume a taxpayer in the 15-percent tax bracket has $1,000 to invest and may choose between two investment alternatives, each of which generates a return of 10 percent annually. Assume the one investment is a certificate of deposit that pays the 10-percent return out annually as interest on which the taxpayer must pay tax. After paying tax, the taxpayer reinvests the principal and net proceeds in a new certificate of deposit. The other investment, stock in a company that pays no dividends, accrues the 10-percent return untaxed until a capital gain is realized. After eight years the after-tax value of the taxpayer's certificate of deposit would be $1,920.[19] After selling the stock and paying tax on the realized gain, the taxpayer would have $1,972.[20] Another way to characterize the benefit of deferral is that the effective rate of taxation on realized capital gains is less than the rate of taxation applicable to assets that pay current income. In this particular example, the effective rate of taxation on the realized capital gain is

[19] This is calculated as $1,000(1 + r(1 - t))^n$, where r is the interest rate (10 percent in this example), t is the marginal tax rate (15 percent in this example), and n is the number of years the asset is held (eight in this example).

[20] This is calculated as the $1,000 principal plus the net, after-tax gain of $(1,000(1 + r)^n - 1,000)(1 - t)$, where r is the interest rate (10 percent), t is the marginal tax rate (15 percent), and n is the number of years the asset is held (eight).

11.4 percent, rather than the statutory tax rate of 15 percent.[21] On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation.

Is a differential in rates consistent with policy makers' equity goals?

A lower rate of tax for income from capital gains compared to the tax rate applicable to other income will benefit directly those taxpayers who hold assets with accrued capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. Tax return data contain information on which taxpayers have realized capital gains in the past. These data reveal that many taxpayers realize a capital gain from time to time, but the majority of the dollar value of gains realized is by taxpayers who frequently realize capital gains. Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, the bulk of the dollar value of any tax reduction will go to those taxpayers who realize the bulk of the dollar value of gains.

The data also suggest that taxpayers who infrequently realized capital gains generally have lower incomes than those taxpayers who frequently realized capital gains. These findings have been criticized because income is sometimes measured including the realized gain. However, attempts to account for this problem by measuring income less realized gains or by using a measure of income averaged over a period of years generally reveal that a large portion of the dollar value of gains are realized by higher-income taxpayers while a large portion of the transactions in which gains are realized are undertaken by the remaining taxpayers. Such findings are consistent with information on the ownership of assets in the United States. Higher-income taxpayers generally hold a larger proportion of corporate stock and other capital assets than do other taxpayers. Thus, while many taxpayers may benefit from a lower rate of tax on income from capital gains, a larger proportion of the dollar value of a lower tax rate on capital gain income will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.

Complexity and tax rate differentials for income from dividends and capital gains

The combination of present law and the proposed changes of the President's Fiscal Year 2010 budget proposal creates a complex structure of tax rates for different types of investments.

Tables 1 through 3, below, detail the tax rates applicable to income from different investments yielding income from dividends and capital gains.

[21] The effective rate of taxation on a realized gain is calculated by asking what rate of tax on an asset that paid current income would yield an equivalent amount of net proceeds to the taxpayer if that asset were held until the taxpayer realized the capital gain.

Table 1.–Tax Rates Applicable Under Present Law to Certain Categories of Income, 2009-2010

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**35%**	**26%**	**28%**
Dividend income	0	0	15	15	15	15	same as regular tax	
Short-term capital gain[1]	10	15	25	28	33	35	26	28
Long-term capital gain[2]	0	0	15	15	15	15	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	26	28
Small business stock[4]	0	0	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock[5]	0	0	10	11.2	11.2	11.2	11.592	12.476
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0	0

Notes:
See notes at end of Table 3.

Table 2.–Tax Rates Applicable Under Present Law to Certain Categories of Income, 2011 and Thereafter

	Regular Tax Rate Bracket					Minimum Tax Rate Bracket	
Category of income	**15%**	**28%**	**31%**	**35%**	**39.6%**	**26%**	**28%**
Dividend income	15	28	31	35	39.6	26	28
Short-term capital gain[1]	15	25	31	35	39.6	26	28
Long-term capital gain[2]	10	20	20	20	20	same as regular tax	
Section 1250 gain[3]	15	25	25	25	25	25	25
Collectible gain	15	28	28	28	28	26	28
Small business stock issued before February 18, 2009[4]	7.5	14	14	14	14	18.46[7]	19.88[7]
Empowerment zone small business stock issued before February 18, 2009	6	11.2	11.2	11.2	11.2	14.768	15.904
Small business stock issued after February 17, 2009	3.75	7	7	7	7	11.76	12.88
Five-year gain acquired before 2001	8	20	20	20	20	same as regular tax	
Five-year gain acquired after 2000	8	18	18	18	18	same as regular tax	
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0

Notes:
See notes at end of Table 3.

Table 3.–Tax Rates Applicable Under Administration Proposal to Certain Categories of Income, 2011 and Thereafter

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**36%**	**39.6%**	**26%**	**28%**
Dividend income	0	0	15	15	20	20	same as regular tax	
Short-term capital gain[1]	10	15	25	28	36	39.6	26	28
Long-term capital gain[2]	0	0	15	15	20	20	same as regular tax	
Section 1250 gain[3]	10	15	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	26	28
Small business stock issued before February 18, 2009[4]	0	0	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock issued before February 18, 2009	0	0	10	11.2	11.2	11.2	11.592	12.476
Small business stock issued after February 17, 2009	0	0	0	0	0	0	0	0
D.C. Enterprise Zone stock/Renewal Community stock[6]	0	0	0	0	0	0	0	0

Notes:
[1] Gain from assets held not more than one year.
[2] Gain from assets held more than one year not included in another category.
[3] Capital gain attributable to depreciation on section 1250 property (i.e., depreciable real estate).
[4] Effective rates after application of 50-percent exclusion for small business stock held more than five years.
[5] Effective rates after application of 60-percent exclusion for small business empowerment zone stock held more than five years.
[6] D.C. Enterprise Zone stock issued after December 31, 1997, and before January 1, 2010, and Renewal Community stock issued after December 31, 2001, and before January 1, 2010. The stock must be held for more than five years.
[7] If the holding period for the stock begins after 2000, the rates are 16.64% and 17.92%, respectively.

Beyond any difficulties the various rates may create for a taxpayer's calculation of his or her tax liability, opponents of a preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax Code and in judicial rules, has developed in response to conflicting taxpayer and IRS positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the

results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service.

Furthermore, it is argued that so long as a limitation on deductions of capital loss is retained, some areas of uncertainty and dispute will continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business). Because limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the potential for simplification and consistency may be limited.

Prior Action

The American Recovery and Reinvestment Tax Act of 2009 changed the applicable tax rates for small business stock issued after February 17, 2009, and before January 1, 2011.

B. Marginal Individual Income Tax Rate Reductions

Present Law

In general

The Economic Growth and Tax Relief Reconciliation Act of 2001[22] ("EGTRRA") created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were lowered to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. These provisions of EGTRRA shall cease to apply for taxable years beginning after December 31, 2010.

Tax rate schedules

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2009, the regular individual income tax rate schedules are as follows:

[22] Pub. L. No. 107-16.

Table 4.–Federal Individual Income Tax Rates for 2009

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,350	10% of the taxable income
Over $8,350 but not over $33,950	$835 plus 15% of the excess over $8,350
Over $33,950 but not over $82,250	$4,675 plus 25% of the excess over $33,950
Over $82,250 but not over $171,550	$16,750 plus 28% of the excess over $82,250
Over $171,550 but not over $372,950	$41,754 plus 33% of the excess over $171,550
Over $372,950	$108,216 plus 35% of the excess over $372,950
Heads of Households	
Not over $11,950	10% of the taxable income
Over $11,950 but not over $45,500	$1,195 plus 15% of the excess over $11,950
Over $45,500 but not over $117,450	$6,227.50 plus 25% of the excess over $45,500
Over $117,450 but not over $190,200	$24,215 plus 28% of the excess over $117,450
Over $190,200 but not over $372,950	$44,585 plus 33% of the excess over $190,200
Over $372,950	$104,892.5 plus 35% of the excess over $372,950
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $16,700	10% of the taxable income
Over $16,700 but not over $67,900	$1,670 plus 15% of the excess over $16,700
Over $67,900 but not over $137,050	$9,350 plus 25% of the excess over $67,900
Over $137,050 but not over $208,850	$26,637.50 plus 28% of the excess over $137,050
Over $208,850 but not over $372,950	$46,741.50 plus 33% of the excess over $208,850
Over $372,950	$100,894.50 plus 35% of the excess over $372,950
Married Individuals Filing Separate Returns	
Not over $8,350	10% of the taxable income
Over $8,350 but not over $33,950	$835 plus 15% of the excess over $8,350
Over $33,950 but not over $68,525	$4,675 plus 25% of the excess over $33,950
Over $68,525 but not over $104,425	$13,318.75 plus 28% of the excess over $68,525
Over $104,425 but not over $186,475	$23,310.75 plus 33% of the excess over $104,425
Over $186,475	$50,447.25 plus 35% of the excess over $186,475

Description of Proposal

The proposal permanently extends the 10-percent, 15-percent, 25-percent and 28-percent individual income tax rates. For taxable years beginning after December 31, 2010, the 33-percent rate and the 35-percent rate brackets become 36-percent and 39.6 percent, respectively. Finally the proposal widens the tax rate bracket for the 28-percent rate so that individuals with less than $190,650 of taxable income adjusted gross income ($200,000 of adjusted gross income ("AGI"), assuming one personal exemption and the basic standard deduction) will not be subject to the new 36-percent rate. For joint returns and surviving spouses, the dollar threshold for the new 36-percent bracket is set so that married couples and surviving spouses with adjusted gross income below $231,300 of taxable income ($250,000 of AGI, assuming two personal exemptions and the basic standard deduction), currently subject to the 33-percent rate, will not become subject to the new 36-percent rate. For head of household filers, the starting point of the 36-percent bracket is set at the midpoint of the starting points for single filers and married joint filers, rounded down to the nearest $50, or $210,950.

A comparison of Table 5, below, with Table 4, above, illustrates proposed tax rate changes.

Table 5.–Federal Individual Income Tax Rates for 2011
(Using 2009 Dollar Amounts)

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,350	10% of the taxable income
Over $8,350 but not over $33,950	$835 plus 15% of the excess over $8,350
Over $33,950 but not over $82,250	$4,675 plus 25% of the excess over $33,950
Over $82,250 but not over $190,650	$16,750 plus 28% of the excess over $82,250
Over $190,650 but not over $372,950	$47,102 plus 36% of the excess over $190,650
Over $372,950	$112,730 plus 39.6% of the excess over $372,950
Heads of Households	
Not over $11,950	10% of the taxable income
Over $11,950 but not over $45,500	$1,195 plus 15% of the excess over $11,950
Over $45,500 but not over $117,450	$6,227.50 plus 25% of the excess over $45,500
Over $117,450 but not over $210,950	$24,215 plus 28% of the excess over $117,450
Over $210,950 but not over $372,950	$50,395 plus 36% of the excess over $210,950
Over $372,950	$108,715 plus 39.6% of the excess over $372,950
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $16,700	10% of the taxable income
Over $16,700 but not over $67,900	$1,670 plus 15% of the excess over $16,700
Over $67,900 but not over $137,050	$9,350 plus 25% of the excess over $67,900
Over $137,050 but not over $231,300	$26,637.50 plus 28% of the excess over $137,050
Over $231,300 but not over $372,950	$53,027.50 plus 36% of the excess over $231,300
Over $372,950	$104,021.50 plus 39.6% of the excess over $372,950
Married Individuals Filing Separate Returns	
Not over $8,350	10% of the taxable income
Over $8,350 but not over $33,950	$835 plus 15% of the excess over $8,350
Over $33,950 but not over $68,525	$4,675 plus 25% of the excess over $33,950
Over $68,525 but not over $115,650	$13,318.75 plus 28% of the excess over $68,525
Over $115,650 but not over $186,475	$26,513.75 plus 36% of the excess over $115,650
Over $186,475	$52,010.75 plus 39.6% of the excess over $186,475

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

Analysis

The proposal provides tax relief to a large percentage of taxpayers, which will provide incentives for these taxpayers to work, to save, and to invest and, thereby, will have a positive effect on the long-term health of the economy. The proposal also results in increased marginal tax rates on upper income taxpayers (as is provided for by the present-law sunset of EGTRRA), which will correspondingly reduce incentives for these taxpayers to work, to save, and to invest. Opponents of this latter aspect of the proposal often note that many small businesses, and a large fraction of small business income, will be adversely impacted by an increase in the top two tax rates. The staff of the Joint Committee on Taxation estimates that just over 750,000 taxpayers with net positive business income (3 percent of all taxpayers with net positive business income) will have marginal rates of 36 or 39.6 percent under the President's proposal, and that 47 percent of the approximately $1 trillion of aggregate net positive business income will be reported on returns that have a marginal rate of 36 or 39.6 percent.[23]

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

Some opponents of any extension of the EGTRRA rates argue that the projections for prolonged Federal deficits should be dealt with more aggressively even if it requires allowing more of the EGTRRA tax relief to expire. They argue that the long-term economic effects of the increased Federal debt needed to support projected spending and tax relief will adversely affect the United States' long-term economic prospects. Further, they argue that the tax cuts will reduce the ability of the Federal government to pay down the public debt, fund priorities such as education and defense and secure the future obligations of Social Security and Medicare.

Prior Action

Proposals to extend permanently the 10-percent, 15-percent, 25-percent, and 28-percent individual income tax rates were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals.

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

C. Child Tax Credit

Present Law

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

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

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

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

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

Description of Proposal

The proposal permanently extends the $1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT.[24] The provision also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT to ensure that no taxpayer would face an increase in net income tax liability as a result of the interaction of the AMT with the regular income tax reductions in EGTRRA. The proposal permanently extends the earned income formula for determining the refundable child credit, with the earned income threshold of $10,000 (indexed for inflation from 2001). Finally, the proposal permanently extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

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

Analysis

This provision doubles the child tax credit (from $500 to $1,000) to provide additional tax relief to families to help offset the costs of raising a child. Proponents embrace the original arguments made for the EGTRRA provisions as support for permanently extending the provisions. Their principal argument is that a tax credit for families with children recognizes the expense of raising children and the importance of helping families raise children. Further, they argue that the refundable child credit should remain widely available to families regardless of the number of children (rather than only families with three or more children), and thus it is important to extend the earned income formula for determining the refundable credit. Additionally, they believe that the child credit should be allowed to offset the AMT.

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

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals.

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[24] See item IV.C. Increase of Refundable Portion of the Child Credit for a related budget proposal. That proposal permanently extends a refundable child tax credit to the extent of 15 percent of the taxpayer's earned income in excess of $3,000.

D. Marriage Penalty Relief and Earned Income Tax Credit Simplification

Present Law

Marriage penalty

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

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

Basic standard deduction

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

Fifteen percent rate bracket

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

Earned income tax credit

The earned income credit ("EITC") is a refundable tax credit available to certain lower-income individuals. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, and the number of qualifying children. A more complete description of the EITC can be found in section IV. B of this pamphlet.

Description of Proposal

Basic standard deduction

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

15 percent rate bracket

The proposal permanently increases the size of the 15-percent regular income tax rate bracket for married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return. Finally, for married couples who file a joint return, the proposal permanently increases the beginning and ending points of the earned income tax credit phase-out by $5,000.[25]

Earned income tax credit

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

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

Analysis

Basic standard deduction and 15-percent rate bracket

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

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

[25] The amount is indexed for inflation annually.

first $9,350 of his earnings would be tax-free.[26] However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.[27] Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[28] In addition to fairness arguments, proponents argue for continued marriage penalty relief on economic efficiency grounds.

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

Earned income tax credit

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

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[26] As a single taxpayer, the man could claim the standard deduction of $5,700 and one personal exemption of $3,650 for 2009, effectively exempting the first $9,350 of his earnings. This example ignores payroll taxes.

[27] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 28 percent to 15 percent.

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

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals.

E. Education Incentives

Present Law

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

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under section 117 are also excludable from wages for payroll tax purposes.[29]

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

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

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

Income and wage exclusion for employer-provided educational assistance

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

[29] Sec. 3121(a)(20).

purposes and from wages for employment tax purposes.[30] This exclusion applies to both graduate and undergraduate courses.[31] For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

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

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.[32] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

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[30] Secs. 127, 3121(a)(18).

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

[32] Sec. 132(d).

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended ten times.[33] EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.[34]

Deduction for student loan interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.[35] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

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

The maximum allowable deduction per year is $2,500. For 2009, the deduction is phased out ratably for single taxpayers with AGI between $60,000 and $75,000 and between $120,000 and $150,000 for married taxpayers filing a joint return. The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

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

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[33] The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

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

[35] Sec. 221.

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

Coverdell education savings accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[36] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.[37] However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[38]

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

Qualified education expenses include "qualified higher education expenses" and "qualified elementary and secondary education expenses."

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

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[36] Sec. 530.

[37] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

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

educational institution on a full-time, half-time, or less than half-time basis.[39] Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.[40]

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

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

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

[39] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

[40] Sec. 530(b)(2)(B).

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

Amount of governmental bonds that may be issued by governments qualifying for the "small governmental unit" arbitrage rebate exception

To prevent State and local governments from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.[41] The Code also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issues of governmental bonds issued for local governmental activities are not subject to the rebate requirement.[42] To qualify for this exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[43] Prior to EGGTRA, the $5 million limit was increased to $10 million if at least $5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from $5 million to $10 million.[44] Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset.

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

Interest on bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue act. These bonds are called "private activity bonds."[45] The term "private person" includes the Federal government and all other individuals and entities other than State or local governments.

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

[42] Ninety-five percent or more of the net proceeds of governmental bond issue are to be used for local governmental activities of the issuer. Sec. 148(f)(4)(D).

[43] Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. 1.148-8(c)(1).

[44] Sec. 148(f)(4)(D)(vii).

[45] The Code provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of section 141. See secs. 103(b)(1) and 141.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency.[46] The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

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

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

Description of Proposal

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

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

Analysis

Individual benefits

The present-law education tax benefits for individuals that are scheduled to expire under the EGTRRA sunset provision are intended to provide taxpayers with some financial relief for education expenses previously incurred (the modifications to the deduction for student loan interest), for current education expenses (the income and wage exclusion for awards under the

[46] Sec. 142(a)(13) and (k).

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

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

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

Bonds for public school facilities

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

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

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals.

F. Modify and Make Permanent the Estate, Gift, and Generation Skipping Transfer Taxes After 2009

Present Law

In general

A gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Exemption equivalent amounts and applicable tax rates

In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death. The unified credit offsets tax computed at the lowest estate and gift tax rates.

Prior to 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continue to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes is increased above the effective exemption amount allowed for gift tax purposes, as described below. In 2009, the highest estate and gift tax rate is 45 percent. The unified credit effective exemption amount is $3.5 million for estate tax purposes and $1 million for gift tax purposes.

In 2009 and after 2010 the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

Repeal of estate and generation skipping transfer taxes in 2010; modifications to gift tax

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a $1 million exemption amount and a gift tax rate equal to the top individual income tax rate of 35 percent. Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010

The estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted will apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million will apply for purposes of determining the tax on cumulative taxable transfers made by a taxpayer by lifetime gift or bequest.

Basis in property received

In general

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

Basis in property received by lifetime gift

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

Basis in property received from a decedent who dies before 2010

Under present law in effect through 2009, property passing from a decedent's estate generally takes a "stepped-up" basis. In other words, the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death is less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of "income in respect of a decedent." The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was in the hands of the decedent) increased by estate tax paid on that asset. Income in respect of a decedent includes rights to income that have been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under present law in effect through 2009, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Under present law in effect through 2009, stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock or securities in a foreign personal holding company take a carryover basis, and stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis.

Basis in property received from a decedent who dies during 2010

In 2010, upon repeal of the estate tax, the rules providing for date-of-death fair market value ("stepped-up") basis in property acquired from a decedent are repealed, and a modified carryover basis regime is to take effect.[47] Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent.[48] Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

An executor generally may increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In

[47] Sec. 1022.

[48] Secs. 1014(b)(2) and (3).

addition, the basis of property transferred to a surviving spouse may be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses may be increased by a total of $4.3 million. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to $60,000. The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2010.

Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. After that time, the law in effect prior to 2010, which generally provides for date-of-death fair market value ("stepped-up") basis in property passing from a decedent, will apply.

State death tax credit; deduction for State death taxes paid

State death tax credit under prior law

Prior to 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which serves to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement

of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 will apply.

Exclusions and deductions

Gift tax annual exclusion

Under present law, donors of lifetime gifts are provided an annual exclusion of $13,000 (for 2009) on transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $26,000 for 2009. The dollar amounts are indexed for inflation.

Transfers to a surviving spouse

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

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

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

Conservation easements

Under present law, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $500,000.[49] The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement

[49] Sec. 2031(c).

is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Prior to 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance of a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modification to expand the availability of qualified conservation contributions does not apply for decedents dying after December 31, 2010.

Provisions affecting small and family-owned businesses and farms

Special-use valuation

An executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $1 million for 2009. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years immediately preceding the decedent's death.

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

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to $675,000.[50] A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

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

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the qualified family-owned business deduction will apply to estates of decedents dying after December 31, 2010.

Installment payment of estate tax for closely held businesses

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less

[50] The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount of $625,000 is increased by the difference between $675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above $675,000. Because of the coordination between the qualified family-owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds $1.3 million.

certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1.33 million (as adjusted annually for inflation occurring after 1998; the original amount for 1998 was $1 million) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1.33 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

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

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

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

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

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal

and interest) relating to a qualifying property interest held through holding companies over five years.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

Generation-skipping transfer tax rules

In general

A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

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

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

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

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

Modifications to the generation skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

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

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax

exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation skipping transfer tax exemption allocation.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

Sunset of EGTRRA modifications to the generation skipping transfer tax rules

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modifications to the generation skipping transfer tax rules described above do not apply for generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001 will apply.

Description of Proposal

The proposal generally makes permanent the present-law estate, gift, and generation skipping transfer tax laws in effect for 2009. Under the proposal, the unified credit effective exemption amount for estate tax purposes generally is $3.5 million for decedents dying during 2010 and later years. The unified credit effective exemption amount for gift tax purposes is $1 million for 2010 and later years. The highest estate and gift tax rate under the proposal is 45 percent, as under present law in effect for 2009. As under present law, the tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the estate tax rate schedule in effect on the date of the decedent's death had been in effect on the date of the prior-year gifts.

As under present law, the generation skipping transfer tax exemption for a given year is equal to the unified credit effective exemption amount for estate tax purposes (e.g., $3.5 million in 2010), and the generation skipping transfer tax rate for a given year will be determined using the highest estate and gift tax rate in effect for such year.

The proposal makes permanent the repeal of the State death tax credit; as under present law in effect for 2009, the proposal allows a deduction for death taxes paid to any State or the District of Columbia. In addition, the proposal makes permanent the repeal of the qualified family-owned business deduction.

The proposal also repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the proposal, a recipient of property acquired from a decedent who dies after December

31, 2009, generally will receive date-of-death fair market value basis (i.e., "stepped up" basis) under the basis rules in effect under present law with respect to decedents dying prior to 2010.

Under the proposal, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions scheduled to occur for decedents dying, gifts made, and generation skipping transfers made after December 31, 2010, is repealed. As a result, the proposal makes permanent the above-described EGTRRA modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the generation skipping transfer tax.

Effective date.−The proposal is effective for estates of decedents dying, generation skipping transfers made, and gifts made after December 31, 2009.

Analysis

Transfer tax planning issues

Stability and consistency in the law

As described above, under EGTRRA the estate tax exemption amount and the estate and gift tax rates have changed on an almost annual basis between 2002 and 2009; the estate and generation skipping taxes are repealed temporarily in 2010, followed by reinstatement of the taxes in 2011 with a lower effective exemption amount and higher top marginal tax rate. Present law provides for two distinct sets of rules for determining basis of assets received from a decedent, depending on whether the decedent dies in 2010 or in a different year. The credit for succession taxes paid to a State was phased out and replaced with a deduction. In addition, increases in the estate tax effective exemption amount resulted in a phase-out and effective repeal of the deduction for qualified family-owned business interests under section 2057, but section 2057 again will be operative for 2011 and later years. Certain other modifications to the estate and gift tax laws under EGTRRA are scheduled to expire at the end of 2010.

Commentators have advocated a stable and more predictable estate and gift tax system -- without constantly changing parameters, phase-outs, or sunsets -- arguing that the complexity of current law has made estate planning difficult and costly. The American Bar Association's Task Force on Federal Wealth Transfer Taxes argued that, because of the complexity of current law, "[a] significant number of individuals likely will have estate plans with provisions that are inappropriate."[51] This could arise, for example, because estate planners fail to plan properly for changes in law, taxpayers are reluctant to incur the transaction costs associated with repeatedly modifying estate plans, or taxpayers choose to delay further planning in the hope that they will not die before the estate tax is permanently repealed or substantially reduced. As another example, the ABA Task Force notes that some taxpayers wish to maintain life insurance only if

[51] American Bar Association, Task Force on Federal Wealth Transfer Taxes, "Report on Reform of Federal Wealth Transfer Taxes" (2004) (hereinafter "ABA Task Force"), p. 3.

they will have an estate tax liability, but this is difficult to determine when the estate tax laws are unsettled and changing.[52]

Differences in estate and gift tax effective exemption amounts

As described above, under present law as in effect for 2009 and under the budget proposal, the gift tax effective exemption amount remains $1 million, while the estate tax effective exemption amount is $3.5 million. Commentators have argued that this decoupling of the estate and gift tax exemption amounts complicates wealth transfer tax planning and raises administrability issues, and that the exemption amounts, therefore, should be reunified.

For example, some commentators argue that, as a result of the lower gift tax exemption amount, taxpayers are likely to engage in complicated and costly planning to avoid gift tax.[53] They argue that the lower gift tax exemption (and resulting higher cost of the gift tax) could encourage taxpayers to create complicated long-term trusts at death designed to avoid gift tax on transfers to successive generations. They further argue that the lower gift tax exemption will encourage taxpayers to delay transfers until death, "encouraging family wealth to remain 'locked in' older generations."[54]

The extent to which such practices have increased in use since the exemption amounts were decoupled in 2004 is uncertain. In addition, the effect of the lower gift tax exemption amount from 2004 through 2009 is partially mitigated by a structural difference between the estate tax and the gift tax that generally benefits taxpayers who make inter vivos gifts: the gift tax is "tax exclusive," whereas the estate tax is "tax inclusive." In other words, under the estate tax, the assets used to pay the tax are included in the estate tax base. Thus, if the estate and gift taxes were fully reunified, the gift tax would be a less costly tax.

Furthermore, the gift tax often is viewed as being necessary to protect the income tax base. In the absence of a gift tax, it may be possible for a taxpayer to transfer an asset with built-in gain or that produces income to a taxpayer who is in a lower tax bracket, where the gain or income would be realized and taxed at a lower rate before the asset is returned to the original holder. Therefore, if the gift tax effective exemption amount were increased to equal the higher estate tax exemption amount, the effectiveness of the gift tax as a tool to protect the income tax base may be diminished.

Treatment of State death taxes for Federal estate tax purposes

Prior to 2002, Federal law allowed for a credit against the Federal estate tax for any estate, inheritance, legacy or succession taxes (referred to as "State death taxes") actually paid to any State or the District of Columbia.[55] The credit was determined under a graduated rate table

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[52] *Ibid*., pp. 3-5.

[53] *Ibid*., p. 22.

[54] *Ibid*., pp. 22-23.

[55] Sec. 2011.

set forth in section 2011(b), which ties the maximum credit amount to the "adjusted taxable estate," which is the taxable estate reduced by $60,000. Under EGTRRA, the amount of the allowable credit was reduced from 2002 through 2004. For decedents dying after 2004, the credit is replaced with a deduction from the gross estate for State death taxes actually paid to any State or the District of Columbia.[56] The budget proposal makes permanent the present-law State death tax deduction.

Before the credit was repealed, many States imposed "soak-up" or "pick-up" taxes, *i.e.*, State taxes designed to impose a tax equal to the maximum amount of the Federal credit allowed to a decedent. Such taxes had the effect of shifting revenue to States from the Federal government, without changing the overall amount of estate tax liability (Federal and State) of a taxpayer. Under prior law, all of the States imposed a tax at a level at least equal to the amount of the State death tax credit allowed under section 2011.[57] As of July 1, 2009, however, 27 States impose no State death taxes.[58]

Some argue that the State death tax credit should be reinstated rather than retaining the present-law deduction. They argue, for example, that the credit served as a powerful funding mechanism for States; because States are struggling financially in the current economy, the States are in critical need of such funding. Furthermore, because it is politically difficult to enact new taxes in many States, some State legislatures have been unable or unwilling to replace existing soak-up taxes (which in some cases now lie dormant because such laws operate only to the extent Federal law allows a credit for State death taxes) with new estate or inheritance taxes, leaving such States without needed revenue. Some advocates of reinstating the State death tax credit also argue that the absence of Federal credit increases the disparity in estate taxes imposed by the various States, which can (1) lead to competition between States to attract wealthy residents and (2) result in disparate tax treatment of similarly situated individuals, depending only on an individual's State of residence at the time of death.[59]

Others argue that the State death tax credit should not be reinstated. Some argue, for example, that estate or other succession taxes, whether Federal or State, are undesirable and that the allowance of a Federal credit for State death taxes is a subsidy to States that encourages the enactment or retention of State-level death taxes. Some might also argue that if the intended policy is to provide a funding mechanism for State governments, it would be more direct and efficient to provide a direct Federal government subsidy instead of making a tax expenditure through the tax system.

[56] Sec. 2058.

[57] ABA Task Force, p. 8.

[58] See McGuire Woods LLP, 2009 State Death Tax Chart (Revised July 1, 2009), available at *http://mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf*.

[59] See, e.g., Jeffrey A. Cooper, "Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective," 33 *Pepperdine Law Review* 835 (2006).

Federal estate tax and basis of transferred assets

As described previously, present law includes two sets of rules for determining the basis of property acquired from a decedent's estate. The basis of property acquired from estates of decedents dying anytime before or after 2010 generally is the property's fair market value at the time of the decedent's death. As a result of this basis step-up (or step-down if property declined in value while owned by the decedent) when a taxpayer sells inherited property, the taxpayer generally does not recognize gain or loss attributable to appreciation or depreciation in the property that occurred during the decedent's holding period. Present law provides a different rule for property acquired from estates of decedents dying in 2010. For this property, there is no Federal estate tax, but heirs generally take a carryover basis. This carryover basis preserves in the hands of an heir taxable gain or loss attributable to increases or decreases in the value of property during the decedent's holding period. The one-year change from an estate tax coupled with basis step-up (or step-down) to estate tax repeal with carryover basis raises several behavioral and administrative issues. A few significant issues are described below.

Carryover basis may affect a taxpayer's willingness to sell an appreciated asset. In general, a realization-based tax system creates "lock-in," a behavioral distortion that may be described as the reluctance of an individual to sell property and thereby incur tax on the recognition of accrued appreciation in the property. This lock-in reduces the mobility of capital to potentially higher return investments. Proponents of carryover basis argue that allowing inherited property to receive a basis step-up accentuates lock-in. Because income taxes on accrued appreciation can be avoided entirely if the basis of property that passes at death is stepped up to its fair market value at the time of death, an individual may choose not to sell appreciated property before death. Under this argument, carryover basis would reduce lock-in because holding assets until death would not permit avoidance of income tax liability on pre-death appreciation when assets eventually are sold by heirs. Conversely, opponents of carryover basis argue that it perpetuates lock-in because income tax liability for pre-death gains carries over to the heir. Thus, under carryover basis the decedent's beneficiary also may refrain from selling an asset because of the adverse income tax consequences from sale. Opponents of carryover basis argue that the stepped-up basis rule removes the lock-in effect once each generation.

Under carryover basis, taxpayers will be required to establish a decedent's historical cost basis in inherited assets. Commentators have argued that establishing this historical cost basis may be difficult in many cases.[60] The difficulty may be acute in part because the decedent is no longer available to remember the history of assets and where records of transactions affecting basis might be located. This problem may be especially troublesome in the case of personal residences for which there may be many transactions that affect basis; personal effects such as jewelry; assets such as classic cars that appreciate in value and to which many improvements

[60] Nonna A. Noto, "Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal," CRS Report for Congress RL30875, p. 9 (updated Apr. 20, 2001). The report notes that practitioners raised this concern when a previous attempt to institute carryover basis was enacted (and repealed before taking effect) by the Tax Reform Act of 1976. See also AICPA Tax Division, "Reform of the Estate and Gift Tax System," *Tax Notes* (Apr. 9, 2001), p. 322.

may be made; and unique assets such as paintings and stamp collections. It may be possible to use presumptions to ameliorate the difficulty of establishing historical cost basis. For example, a rule that presumed the decedent purchased an asset at its value on the date of its acquisition would in some cases limit the necessary knowledge to the date the decedent acquired the asset. In the absence of statutory presumptions, if an heir is unable to establish a decedent's basis in property, a question is whether the IRS will consider the heir to have a zero basis in the property.

A related issue under a carryover basis regime is the role of the executor of an estate in determining the decedent's basis in the assets over which the executor has control.[61] When carryover basis rules were adopted in 1976, the executor was required to obtain information about basis and to provide that information to heirs. No such requirement was included in the carryover basis rules adopted in 2001. If rules required executors to provide basis information to beneficiaries or if executors provided information in the absence of a requirement, a question would be whether beneficiaries would be permitted to rely on the information and whether executors would be subject to penalties for failure to report correct or complete information. Although the 2001 rules do not require an executor to provide basis information to beneficiaries, they do provide that an executor must allocate the permitted basis increases (the $1.3 million and $3 million amounts described previously) among estate assets, and they permit broad discretion in making the allocation (subject to a prohibition on using basis additions to create a built-in loss in any single asset). This broad discretion may create difficulties for executors concerned about fiduciary obligations and may create uncertainty for beneficiaries if an executor fails to make an allocation.

Change from a step-up basis rule to a carryover basis regime raises a question whether the change should be accompanied by transition rules. Some individuals may have purchased and held appreciating or depreciable property with the expectation that the basis of the property would be stepped-up upon the individuals' deaths. These individuals may argue that it would be unfair to repeal the stepped-up basis rule at least with respect to amounts of appreciation that have occurred before the time of the rule change. The carryover basis rules adopted in 1976 provided a grandfather rule under which the basis of an inherited asset could not be less than its value on December 31, 1976. Establishing the value of all assets that could be inherited proved to be a difficult and time consuming exercise. EGTRRA's carryover basis rules do not provide a grandfather for pre-carryover basis appreciation.

Economic issues

Wealth taxes, saving, and investment

Some may argue that a reduction in the estate tax for years after 2010, as under the proposal, would affect taxpayers' saving and investment behavior. Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. In particular, there is no

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[61] AICPA Tax Division, supra note 82, p. 326; Task Force on Federal Wealth Transfer Tax, Report on Reform of Federal Wealth Transfer Taxes 72 (2004); Karen C. Burke and Grayson M.P. McCouch, "Estate Tax Repeal: Through the Looking Glass," 22 *Virginia Tax Review* 187, 220 (2002).

consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run. A related issue is to what extent individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their saving. Again, there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.

Some economists believe that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs.[62] It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.[63] Others question the importance of the bequest motive in national capital formation.[64] Nor has direct empirical analysis of the existence of a bequest motive led to a consensus.[65] Theoretically, it is an open question whether estate and gift taxes

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[62] A discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod, eds., *Rethinking the Estate Tax*, (Washington, D.C: The Brookings Institution), 2001. For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," *Journal of Economic Perspectives*, 15, Winter, 2001, pp. 205-218.

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

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

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

encourage or discourage saving, and there has been limited empirical analysis of this specific issue.[66] By raising the after-tax cost of leaving a bequest, a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. For example, some individuals purchase additional life insurance to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Wealth taxes and small business

Regardless of any potential effect on aggregate saving, the scope and design of the transfer tax system may affect the composition of investment. In particular, some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. They note that if a family has a substantial proportion of its wealth invested in one enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained. There is some evidence that many businesses may be constrained by the capital markets in the amount of funds they can borrow. If they are so constrained, they may reduce the amount of investment they undertake, to the detriment of the economy at large.[67] Undercapitalization may be prevalent among small businesses. One study suggests that reduction in estate taxes may have a positive effect on an entrepreneur's survival.[68]

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[66] Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. They find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging successful avoidance activity.

More recently, David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," *National Tax Journal*, 59, June 2006, pp. 253-268, examines the size of taxable estates and the structure of the estate tax and its effects on the expected rates of return to saving. While he emphasizes the sensitivity of the analysis to how individuals' expectations about future taxes are modeled he concludes that "taxable estates are ten percent smaller because of the estate tax."

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

[68] Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102, February 1994, pp. 53-75. Holtz-Eakin, Joulfaian, and Rosen study the effect of receipt of an inheritance on whether an entrepreneur's business survives rather than whether an on-going business that is taxed as an asset in an individual's estate survives. They find that "the effect of inheritance on the probability of surviving as an entrepreneur is small but noticeable: a $150,000 inheritance raises the probability of survival by about 1.3 percentage points," and "[i]f enterprises do survive, inheritances have a substantial impact on their performance: the $150,000 inheritance ... is associated with a nearly 20-percent increase in an enterprise's receipts" (p.74).

Others argue that potential deleterious effects of the estate tax on investment by small or family-owned businesses are limited. The present (2009) and proposed exemption value of the unified credit is $3.5 million per decedent. As a result, small business owners can obtain an effective exemption of up to $7.0 million per married couple, and other legitimate tax planning can further reduce the burden on such enterprises. Also, as described above, Code sections 2031A, 2057,[69] and 6166 are provided to reduce the impingement on small business cash flow that may result from an estate tax liability. Some analysis questions whether, in practice, small businesses need to liquidate operating assets to meet estate tax liabilities. A recent study of 2001 estate returns shows that many estates that claimed benefits under sections 2032A, 2057, or 6166 held liquid assets nearly sufficient to meet all debts against the estate and that only 2.4 percent of estates that reported closely held business assets and agricultural assets elected the deferral of tax under sec. 6166.[70] Others have argued that estate tax returns report a small fraction of the value of decedents' estates thereby mitigating any special burden that the estate tax may impose on small business.[71]

Wealth taxes and labor supply

As people become wealthier, they generally choose to consume more leisure time. Some, therefore, suggest that, by reducing the potential wealth of heirs, transfer taxes may have an effect on labor supply. Over 100 years ago, Andrew Carnegie opined that "the parent who leaves

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These results do not necessarily imply that the aggregate economy is made better off by receipt of inheritances. Survival of the entrepreneur may not be the most highly valued investment that could be made with the funds received. For example, Francisco Perez-Gonzalez, "Inherited Control and Firm Performance," *American Economic Review*, 96, December 2006, pp. 1559-1589, finds that where the incoming CEO is related to the departing CEO, or to a founder, the firm underperforms in terms of profitability and other financial measures.

[69] As discussed above, section 2057 no longer applies for estates of decedents dying after 2003, but will apply to estates of decedents dying after 2010.

[70] Martha Eller Gangi and Brian G. Raub, "Utilization of Special Estate Tax Provisions for Family-Owned Farms and Closely Held Businesses," *SOI Bulletin*, 26, Summer 2006, pp. 128-145. Gangi and Raub calculate a liquidity ratio, the ratio of liquid assets (cash, cash management accounts, State and local bonds, Federal government bonds, publicly traded stock, and insurance on the life of the decedent) to the sum of the net estate tax plus mortgages and liens. They found that in 2001 this ratio exceeded one for estates of less than $2.5 million claiming benefits of the special deduction for qualified family owned business assets or deferral of tax. Larger such estates had average liquidity ratios of 0.5 or more. Generally all estates claiming special use valuations had an average liquidity ratio of at least one. A liquidity ratio of one implies that the estate has liquid assets sufficient to pay the net estate tax plus pay off all mortgages and liens.

[71] See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Tax Avoidance*, (Washington, D.C.: The Brookings Institution), 1979. Also, see B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in Lawrence H. Summers (ed.), *Tax Policy and the Economy* 1 (Cambridge, Mass.: The MIT Press), 1987; and Alicia H. Munnell with Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, November/December 1988. These studies pre-date the enactment of chapter 14 of the Code. The purpose of chapter 14 is to improve reporting of asset values in certain transfers. Nevertheless, planning opportunities remain whereby small business owners can reduce the cash required to meet an estate tax obligation, see Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05, January 27, 2005. The JCT staff discusses the ability to use valuation discounts and lapsing trust powers effectively to shelter business (and other) assets from the estate tax on pages 396-408.

his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would . . ..”[72] While, in theory, increases in wealth should reduce labor supply, empirically economists have found the magnitude of these effects to be small.[73]

In the case of family-owned businesses, the estate tax could increase work effort of heirs as the benefits of the installment payment method, special-use valuation, and the exclusion for qualified family-owned business interests will be lost and recaptured if the assets fail to remain in a qualified use. In addition, the estate tax also could distort, in either direction, the labor supply of the transferor if it distorts his or her decision to make a bequest.

Wealth taxes, the distribution of wealth, and fairness

Some suggest that, in addition to their role in producing Federal revenue, Federal transfer taxes may help prevent an increase in the concentration of wealth. There are relatively few analyses of the distribution of wealth holdings.[74] Conventional economic wisdom holds that the Great Depression of the 1930s and World War II substantially reduced the concentration of wealth in the United States, and that there had been no substantial change at least through the 1980s. Most analysts assign no role to tax policy in the reduction in wealth concentration that occurred between 1930 and 1945. Nor has any analyst been able to quantify what role tax policy might have played since World War II.[75]

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

[73] For a review of this issue, see John Pencavel, “Labor Supply of Men: A Survey,” in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. I, (New York, NY: North-Holland Publishing Co.) 1986. For a direct empirical test of what some refer to as the “Carnegie Conjecture,” see Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, “The Carnegie Conjecture: Some Empirical Evidence,” *Quarterly Journal of Economics*, 108, May 1993, pp. 413-435. Holtz-Eakin, Joulfaian, and Rosen assess the labor force participation of families that receive an inheritance. They find that “the likelihood that a person decreases his or her participation in the labor force increases with the size of the inheritance received. For example, families with one or two earners who received inheritances above $150,000 [in 1982-1985 constant dollars] were about three times more likely to reduce their labor force participation to zero than families with inheritances below $25,000. Moreover, ... high inheritance families experienced lower earnings growth than low inheritance families, which is consistent with the notion that inheritance reduces hours of work” (pp. 432-433). Theory suggests also that those who choose to remain in the labor force will reduce their hours worked or labor earnings. Holtz-Eakin, Joulfaian, and Rosen find these effects to be small.

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

[75] See Michael K. Taussig, “Les inegalites de patrimoine aux Etats-Unis,” in Kessler, Masson, Strauss-Khan (eds.) *Accumulation et Repartition des Patrimoines*. Taussig estimates shares of wealth held by the top 0.5 percent of wealth holders in the United States for various years between 1922 and 1972. Wolff, in “Estimate of

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

Even if transfer taxes are believed to be borne by the owners of the assets subject to tax, an additional conceptual difficulty is whether the tax is borne by the generation of the transferor or the generation of the transferee. The design of the gift tax illustrates this conceptual difficulty. A gift tax is assessed on the transferor of taxable gifts. Assume, for example, a mother makes a gift of $1 million to her son and incurs a gift tax liability of $450,000. From one perspective, the gift tax could be said to have reduced the mother's current economic well-being by $450,000. However, it is possible that, in the absence of the gift tax, the mother would have given her son $1.45 million, so that the gift tax has reduced the son's economic well-being by $450,000. It also is possible that the economic well-being of both was reduced. Of course, distinctions between the donor and donee generations may not be important to assessing the fairness of transfer taxes if both the donor and donee have approximately the same income.[76]

Federal estate taxation and charitable bequests

The two unlimited exclusions under the Federal estate tax are for bequests to a surviving spouse and for bequests to a charity. Because the marginal tax rate under the estate tax is 45 percent, while marginal income tax rates range from 10 to 35 percent, the after-tax cost of a charitable bequest is lower than the after-tax cost of a charitable gift made during one's

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Household Wealth Inequality in the U.S., 1962-1983," does not attribute any movements in wealth distribution directly to tax policy, but rather to the changes in the relative values of housing and corporate stock.

Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior," in William G. Gale, James R. Hines Jr., and Joel Slemrod (eds), *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, find mixed evidence. Using aggregate time series data, Kopczuk and Slemrod find a negative correlation between the share of wealth held by top wealth holders and the estate tax rates. That finding would imply that the estate tax may mitigate the concentration of wealth among top wealth holders. Wojciech Kopczuk and Emmanuel Saez, "Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns," *National Tax Journal*, 57, September 2004, pp. 445-487, report a similar result. However, when Kopczuk and Slemrod use pooled cross section analysis to make use of individual estate tax return data, they find at best a weak relationship between estate tax rates and wealth holdings.

[76] Researchers have found that the correlation of income between parents and children is less than perfect. For analysis of the correlation of income among family members across generations, see Gary R. Solon, "Intergenerational Income Mobility in the United States," *American Economic Review*, 82, June 1992, and David J. Zimmerman, "Regression Toward Mediocrity in Economic Stature," *American Economic Review*, 82, June 1992. These studies, however, examine data relating to a broad range of incomes in the United States and do not directly assess the correlation of income among family members with transferors subject to the estate tax.

lifetime.[77] Economists refer to this incentive as the "price" or "substitution effect." In short, the price effect says that if something is cheaper, people will do more of it. Some analysts have suggested that the charitable estate tax deduction creates a strong incentive to make charitable bequests and that changes in Federal estate taxation could alter the amount of funds that flow to charitable purposes. The decision to make a charitable bequest arises not only from the incentive effect of a charitable bequest's deductibility, or "tax price," but also from what economists call the "wealth effect." Generally the wealthier an individual is, the more likely he or she is to make a charitable bequest and the larger the bequest will be. Because the estate tax diminishes net wealth, the wealth effect would suggest repeal of the estate tax could increase charitable bequests.

A number of studies have examined the effects of estate taxes on charitable bequests. Most of these studies have concluded that, after controlling for the size of the estate and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable bequests.[78] Some analysts interpret these findings as implying that reductions in estate taxation, as under the budget proposal, could lead to a reduction in funds flowing into the charitable sector. This is not necessarily the case, however. Some charitable bequests may substitute for lifetime giving to charity, in part to take advantage of the greater value of the charitable deduction under the estate tax than under the income tax that results from the lower marginal income tax rates and limitations on annual lifetime giving. If this is the case, reductions in the estate tax could lead to increased charitable giving during the taxpayer's life. On the other hand,

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

[78] For example, see Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; David Joulfaian, "Charitable Bequests and Estate Taxes," *National Tax Journal*, 44, June 1991, pp. 169-180; and Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics*, 59, 1996, pp. 55-68. David Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," *National Tax Journal*, 53, September 2000, pp. 743-763, provides a survey of these studies and presents new evidence. Each of these studies estimates a tax price elasticity in excess of 1.6 in absolute value. This implies that for each 10-percent reduction in the tax price, where the tax price is defined as one minus the marginal tax rate, there is a greater than 16-percent increase in the dollar value of charitable bequests. Such a finding implies that charities receive a greater dollar value of bequests than the Treasury loses in forgone tax revenue. In a more recent study, Michael J. Brunetti, "The Estate Tax and Charitable Bequests: Elasticity Estimates Using Probate Records," *National Tax Journal*, 58, June 2005, pp. 165-188, finds price elasticities in excess of 1.2.

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

some analysts have suggested that a more sophisticated analysis is required recognizing that a taxpayer may choose among bequests to charity, bequests to heirs, lifetime gifts to charity, and lifetime gifts to heirs and recognizing that lifetime gifts reduce the future taxable estate. In this more complex framework, reductions in estate taxation could reduce lifetime charitable gifts.[79]

Federal transfer taxes and complexity

Critics of Federal transfer taxes document that these taxes create incentives to engage in avoidance activities. Some of these avoidance activities involve complex legal structures and can be expensive to create. Incurring these costs, while ultimately profitable from the donors' and donees' perspective, is socially wasteful because time, effort, and financial resources are spent that lead to no increase in national wealth. Such costs represent an efficiency loss to the economy in addition to whatever distorting effects Federal transfer taxes may have on other economic choices such as saving and labor supply discussed above. In the case of family-owned businesses, such activities may impose an ongoing cost by creating a business structure to reduce transfer tax burdens that may not be the most efficient business structure for the operation of the business. Reviewing more complex legal arrangements increases the administrative cost of the Internal Revenue Service. There is disagreement among analysts regarding the magnitude of the costs of avoidance activities.[80] It is difficult to measure the extent to which any such costs incurred are undertaken from tax avoidance motives as opposed to succession planning or other motives behind gifts and bequests.

Alternatives to the current U.S. estate tax system

Some argue that, rather than modifying and making permanent the present U.S. estate tax system, Congress should consider an alternative structure. The choice of one form of wealth transfer tax system over another necessarily will involve tradeoffs among efficiency, equity, administrability, and other factors. A determination whether one system is preferable to another could be made on the basis of each system's relative success in achieving one or a majority of these goals, without sacrificing excessively the achievement of the others. Alternatively, such a determination could be made based on which system provides the best mix of efficiency, equity, and administrability.

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[79] Auten and Joulfaian, "Charitable Contributions and Intergenerational Transfers," attempted to estimate this more complex framework. Their findings suggest that reductions in estate taxation would reduce charitable contributions during the taxpayer's life.

[80] Joint Economic Committee, "The Economics of the Estate Tax," December 1998, has stated "the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised." Richard Schmalbeck, "Avoiding Federal Wealth Transfer Taxes," in William G. Gale and Joel B. Slemrod, eds., *Rethinking Estate and Gift Taxation*, (Washington, D.C.: The Brookings Institution), 2001, disagrees writing "[a]bout half of the estate planners consulted in the preparation of this paper reported that they had rather standard packages that they would make available to individuals who would leave estates in the three to ten million range that might be provided for as little as $3000 to $5000." See William G. Gale and Joel B. Slemrod, "Life and Death Questions About the Estate and Gift Tax," *National Tax Journal*, 53, December 2000, pp. 889-912, for a review of the literature on compliance cost.

The United States, State governments, and foreign jurisdictions tax transfers of wealth in many different ways. Some wealth transfer tax systems, for example, impose a tax on the transferor. Such systems include the U.S. estate and gift tax system, which imposes a gift tax on certain gratuitous lifetime transfers, an estate tax on a decedent's estate, and a generation-skipping transfer tax on certain transfers that skip generations. Another approach that involves imposition of a tax on a transferor is a "deemed-realization" approach, under which a gratuitous transfer is treated as a realization event and the gain on transferred assets, if any, generally is taxed to the transferor as capital gain.

Other wealth transfer tax systems tax the transferee of a gift or bequest. Such systems include inheritance (or "accessions") tax systems, under which a tax is imposed against the recipient of a gratuitous transfer. Some jurisdictions do not impose a separate tax, but instead treat receipts of gifts or bequests as gross income of the recipient (an "income inclusion approach").

Regardless of whether the tax is imposed against the transferor or the transferee, some commentators assert that the real economic burden of any approach to taxing transfers of wealth falls on the recipients, because the amount received effectively is reduced by the amount of tax paid by the transferor or realized by the transferee.[81] Some commentators argue that systems that impose a tax based on the circumstances of the transferee –such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries. Others assert that such systems promote fairness in the tax system. However, the extent to which one form of transfer tax system in practice is more effective than another in achieving these goals is not clear.

Wealth transfer tax systems other than an estate tax also may present benefits or additional challenges in administration or compliance. Inheritance taxes or income inclusion systems, for example, may reduce the need for costly tax planning in the case of certain transfers between spouses. At the same time, to the extent such systems are effective in encouraging distributions to multiple recipients in lower tax brackets, they may be susceptible to abuse such as through the use of multiple nominal recipients as conduits for a transfer intended for a single beneficiary.

Prior Action

The President's fiscal year 2002 through 2009 budget proposals included a proposal to make permanent after 2010 the repeal of the estate and generation skipping taxes, as scheduled to be in effect in 2010 under EGTRRA.

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[81] See, e.g., Lily L. Batchelder, "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax," The Hamilton Project, The Brookings Institution, Discussion Paper 2007-07, at 5 (June 2007); "Alternatives to the Current Wealth Transfer Tax System," in American Bar Association, Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes 171 app. A (2004); Joseph M. Dodge, "Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax," *SMU Law Review* 56 (2003), 551, 556.

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

Present Law

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

Present law for 2009 provides: (1) a maximum adoption credit of $12,150 per eligible child (both special needs and non-special needs adoptions); and (2) a maximum exclusion of $12,150 per eligible child (both special needs and non-special needs adoptions). These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a $40,000 range for taxpayers with modified adjusted gross income ("modified AGI") in excess of certain dollar levels. For 2009, the phase-out range is between $182,180 and $222,180. The phaseout threshold is adjusted for inflation annually, but the phaseout range remains a $40,000 range.

For taxable years beginning after December 31, 2010, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to $6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between $75,000 and $115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

Employer-provided child care tax credit

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

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

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

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

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

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

Dependent care tax credit

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

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

Description of Proposals

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

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

Employer-provided child care tax credit

The proposal permanently extends this tax benefit.

Expansion of dependent care tax credit

The proposal permanently extends the dependent care tax credit at current levels.

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

Analysis

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

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

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

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

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

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

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

A separate argument exists for child-care-related tax benefits that relate to child care expenses necessary for employment. The argument is that these child care expenses are an expense of earning income, and thus should essentially be deductible by analogy to general business tax principles that permit deductions for expenses (such as wages paid) necessary to earn income. Furthermore, many economists would argue that a deduction for these expenses would provide income tax treatment that is comparable to the treatment provided home

production of child care–i.e, the value of home production is untaxed since the Code does not impute income to the household that provides child care services. Such households are treated as if they had income imputed to them for the services provided, but coupled with a deduction for such expenses, resulting in no increase in net income. If a worker were provided similar treatment via deductibilty of child care expense, his net taxable income would rise only to the extent that his compensation exceeded that of his child care expenses.

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

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

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

Prior Action

Similar proposals were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals.

H. Reinstate the Personal Exemption Phase-out and Limitation on Itemized Deductions

Present Law

Overall limitation on itemized deductions ("Pease" limitation)

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

The total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's AGI in excess of $166,800 ($83,400 for married couples filing separate returns) for 2009. These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present law limitations applicable to such deductions (such as the separate floors) are first applied, and then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. The otherwise allowable itemized deductions may not be reduced by more than 80 percent.

The overall reduction in itemized deductions is phased down to 1/3 in 2009 and terminates in 2010. However, the limitation is fully effective again in 2011 and thereafter as a result of the EGTRRA sunset provision.

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

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2009, the amount deductible for each personal exemption is $3,650. This amount is indexed annually for inflation. The deduction for personal exemptions is reduced or eliminated for taxpayers with incomes over certain thresholds, which are indexed annually for inflation. The applicable thresholds for 2009 are $166,800 for single individuals, $250,200 for married individuals filing a joint return and surviving spouses, $199,950 for heads of households, and $125,100 for married individuals filing separate returns.

The personal exemption phase-out is phased down to 1/3 in 2009 and terminates in 2010. However, provision is fully effective again in 2011 and thereafter as a result of the EGTRRA sunset provision.

Description of Proposal

Overall limitation on itemized deductions ("Pease" limitation)

The proposal modifies the overall limitation on itemized deductions. Specifically, the overall limitation on itemized deductions applies with a new AGI level beginning in 2011.[82] For 2011, the AGI level is determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This 2009 dollar amount is $200,000 ($250,000 for joint returns). Future years are adjusted for inflation also.

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

The proposal modifies the personal exemption phase-out. Specifically, the personal exemption phase-out applies with a new AGI level beginning in 2011.[83] For 2011 the AGI level is determined by taking a 2009 dollar amount and adjusting for subsequent inflation. This dollar amount is: (1) $200,000 for unmarried individuals; (2) $250,000 for joint returns; and (3) $125,000 for married couples filing separately. Future years are adjusted for inflation also.

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

Analysis

Overall limitation on itemized deductions ("Pease" limitation)

The general limitation on itemized deductions increases the effective marginal tax rate for affected taxpayers. This limitation reduces (subject to the 80 percent limitation) the amount of certain itemized deductions that may be claimed by an amount equal to 3 percent of each dollar of income in excess of the threshold. Thus if a taxpayer who is above the threshold earns an additional $1.00 of income, the taxpayer's taxable income increases by $1.03 because the taxpayer's income goes up by $1.00 and the itemized deductions must be reduced by 3 cents. The statutory tax rates apply to taxable income. Thus, if the taxpayer is in the 36 percent tax bracket, the increase in tax liability resulting from the $1.00 increase in income will be $0.37 (the $1.03 in additional taxable income multiplied by 0.36). Generally, the effective marginal tax rate for taxpayers subject to the limitation on itemized deductions is 3 percent higher than the statutory tax rate. That is, the taxpayer's effective marginal tax rate equals 103 percent of the statutory marginal tax rate. Once the taxpayer's itemized deductions are reduced by 80 percent, the taxpayer's effective marginal tax rate again equals his or her statutory marginal tax rate.

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[82] The repeal of the overall limitation on itemized deductions for 2010 provided under present law is not affected by this proposal.

[83] The repeal of the personal exemption phase-out for 2010 provided under present law is not affected by this proposal.

Some argue that the limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions. While there may be a psychological effect, there generally is little or no difference in the tax motivated economic incentive to give to charity for a taxpayer subject to the limitation compared to a taxpayer not subject to the limitation. This is because while the limitation operates effectively to increase the marginal tax rate on the income of affected taxpayers, the value of the tax benefit of deductibility of the charitable deduction is determined by the statutory tax rate. For taxpayers beyond the threshold, a specified dollar amount of itemized deductions are denied. The specified dollar amount is determined by the taxpayer's income, not by the amount of itemized deductions the taxpayer claims. Hence, the value of an additional dollar contributed to charity increases by exactly one dollar times the total amount of itemized deductions that the taxpayer may claim. Because the statutory rates apply to taxable income (income after claiming permitted itemized deductions), the value of the additional contribution to charity is determined by the statutory tax rate. Economists would say that the "tax price" of giving is not altered by the limitation.[84]

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

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

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

The personal exemption phaseout increases effective marginal tax rates for those affected taxpayers. The personal exemption phaseout operates by reducing the amount of each personal

[84] This can be seen mathematically as follows. Let Y be the taxpayer's income and X be the threshold above which the limitation on itemized deductions applies. Let D be itemized deductions and t the taxpayer's marginal tax rate. Then the taxpayer's total tax liability, T, is:

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

or

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

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

exemption that the taxpayer may claim by two percent for each $2,500 (or portion thereof) by which the taxpayer's income exceeds the designated threshold for his or her filing status. Thus, for a taxpayer who is subject to the personal exemption phaseout, earning an additional $2,500 will reduce the amount of each personal exemption he or she may claim by two percent, or by $73 in 2009 (0.02 times the $3,650 personal exemption). The taxpayer's additional taxable income is thus equal to the $2,500 plus the $73 in denied exemption for each personal exemption. For a taxpayer in the 36 percent statutory marginal tax rate bracket, the effective marginal tax rate on the additional $2,500 of income equals the statutory 36 percent plus an additional 1.05 percent ($73 times the statutory rate of 0.36, divided by the $2,500 in incremental income) for each personal exemption. Thus, if this taxpayer claims four personal exemptions, his or her effective marginal tax rate is 40.2 percent (the statutory 36 percent rate plus four times 1.05 percent). More generally, for 2009 the taxpayer's effective marginal tax rate equals the taxpayer's statutory marginal rate multiplied by one plus the product of 2.92 percentage points (the $73 in denied personal exemption divided by the incremental $2,500 in income) multiplied by the number of personal exemptions claimed by the taxpayer. Thus, a taxpayer who claims four personal exemptions would have an effective marginal tax rate approximately 111.7 percent of the statutory marginal tax rate.

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

Opponents of the reinstatement argue that the high costs of raising children should properly be reflected at all levels of the income distribution, on the grounds that the millionaire without children should face a higher tax burden than the millionaire with children, in the same manner that the couple earning $50,000 without children is required to pay more tax than the couple earning $50,000 with children. Opponents further argue that the personal exemption phase-out imposes excessively high effective marginal tax rates on families with children, is an unnecessarily complex way to impose income taxes, and that the "hidden" way in which the phase-out raises taxes undermines respect for the tax laws.

Prior Action

Proposals to repeal the EGTRRA sunset with regard to the personal exemption phase-out and the limitation on itemized deductions were contained in the President's fiscal year 2003, 2004, 2005, 2006, 2007, 2008, and 2009 budget proposals.

III. TAX CUTS FOR FAMILIES AND INDIVIDUALS

A. Provide Making Work Pay Tax Credit

Present Law

In general

Present law provides eligible individuals a refundable income tax credit for taxable years beginning in 2009 and 2010.

The credit is the lesser of (1) 6.2 percent of an individual's earned income or (2) $400 ($800 in the case of a joint return). For these purposes, the earned income definition is the same as for the earned income tax credit with two modifications. First, earned income for these purposes does not include net earnings from self-employment which are not taken into account in computing taxable income. Second, earned income for these purposes includes combat pay excluded from gross income under section 112.

The credit is phased out at a rate of two percent of the eligible individual's modified adjusted gross income ("modified AGI") above $75,000 ($150,000 in the case of a joint return). That is, if an individual's modified AGI exceeded the threshold by, for example, $1,000, the individual's otherwise allowable credit would be reduced by two percent of $1,000, or $20. For these purposes an eligible individual's modified AGI is the eligible individual's adjusted gross income increased by any amount excluded from gross income under sections 911, 931, or 933. An eligible individual means any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another individual may claim a dependency deduction for a taxable year beginning in a calendar year in which the eligible individual's taxable year begins; and (3) an estate or trust.

The otherwise allowable making work pay credit allowed under the provision is reduced by the amount of any payment received by the taxpayer pursuant to provisions of present law providing economic recovery payments under the Veterans Administration, Railroad Retirement Board, and the Social Security Administration and a temporary refundable tax credit for certain government retirees.[85] Present law treats the failure to reduce the making work pay credit by the amount of such payments or credit, and the omission of the correct TIN, as mathematical or clerical errors. This allows the IRS to assess any tax resulting from such failure or omission without the requirement to send the taxpayer a notice of deficiency allowing the taxpayer the right to file a petition with the Tax Court.

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[85] The credit for certain government employees is available for 2009. The credit is $250 ($500 for a joint return where both spouses are eligible individuals). An eligible individual for these purposes is an individual: (1) who receives an amount as a pension or annuity for service performed in the employ of the United States or any State or any instrumentality thereof, which is not considered employment for purposes of Social Security taxes; and (2) who does not receive an economic recovery payment under the Veterans Administration, Railroad Retirement Board, or the Social Security Administration.

Each tax return on which this credit is claimed must include the social security number of the taxpayer (in the case of a joint return, the social security number of at least one spouse).

Treatment of the U.S. possessions

Mirror code possessions[86]

The U.S. Treasury will make payments to each mirror code possession in an amount equal to the aggregate amount of the credits allowable by reason of the provision to that possession's residents against its income tax. This amount will be determined by the Treasury Secretary based on information provided by the government of the respective possession. For purposes of these payments, a possession is a mirror code possession if the income tax liability of residents of the possession under that possession's income tax system is determined by reference to the U.S. income tax laws as if the possession were the United States.

Non-mirror code possessions[87]

To each possession that does not have a mirror code tax system, the U.S. Treasury will make two payments (for 2009 and 2010, respectively) in an amount estimated by the Secretary as being equal to the aggregate credits that would have been allowed to residents of that possession if a mirror code tax system had been in effect in that possession. Accordingly, the amount of each payment to a non-mirror Code possession will be an estimate of the aggregate amount of the credits that would be allowed to the possession's residents if the credit provided by the provision to U.S. residents were provided by the possession to its residents. This payment will not be made to any U.S. possession unless that possession has a plan that has been approved by the Secretary under which the possession will promptly distribute the payment to its residents.

General rules

No credit against U.S. income tax is permitted under the provision for any person to whom a credit is allowed against possession income taxes as a result of the provision (for example, under that possession's mirror income tax). Similarly, no credit against U.S. income tax is permitted for any person who is eligible for a payment under a non-mirror code possession's plan for distributing to its residents the payment described above from the U.S. Treasury.

For purposes of the payments to the possessions, the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands are considered possessions of the United States.

For purposes of the rule permitting the Treasury Secretary to disburse appropriated amounts for refunds due from certain credit provisions of the Internal Revenue Code of 1986, the

[86] Possessions with mirror code tax systems are the United States Virgin Islands, Guam, and the Commonwealth of the Northern Mariana Islands.

[87] Possessions that do not have mirror code tax systems are Puerto Rico and American Samoa.

payments required to be made to possessions under the provision are treated in the same manner as a refund due from the credit allowed under the provision.

Federal programs or Federally-assisted programs

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Income tax withholding

Present law provides for a more accelerated delivery of the credit in 2009 through revised income tax withholding schedules produced by the U.S. Treasury. These revised income tax withholding schedules would be designed to reduce taxpayers' income tax withheld for the remainder of 2009 in such a manner that the full annual benefit of the provision is reflected in income tax withheld during the remainder of 2009.

Description of Proposal

The proposal extends the making work pay credit permanently. The proposal decreases the rate at which the credit phases out from two percent to 1.6 percent. Thus, for example, if an individual's modified AGI were to exceed the threshold at which the phaseout begins by $1,000, the individual's otherwise allowable credit would be reduced by 1.6 percent of $1,000, or $16, rather than two percent of $1,000, or $20, as under current law. Finally, the proposal indexes the income tax thresholds for the phase-out of the credit for inflation beginning in 2011.

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

Analysis

The proposal makes the making work pay credit a permanent feature of the tax code, reducing tax revenues and adding to budget deficits henceforth, rather than reducing revenues only temporarily for the purposes of economic stimulus.

Proponents of the proposal argue that the tax burdens on working families eligible for the making work pay credit are too high, and that a permanent extension is justified to reduce this burden and offset the regressivity of the Social Security payroll taxes. Proponents argue that this reduction in the overall tax liability for working Americans would encouraged work, savings and investment, contributing to the long-term health of the economy.

Critics of the proposal note that long-term fiscal picture of the United States is bleak, and that new revenues will be needed to meet the needs of an aging population. Thus, further tax cuts should not be contemplated at this time in their view. These critics would prefer that any income tax based offsets to payroll taxes would best be contemplated in the context of reform of the Social Security system.

Critics of the proposal further note that the credit will provide little in the way of work or saving incentives, because the credit is "inframarginal" for most taxpayers—that is, while the credit reduces tax liability, it does not change the marginal tax rate at which most credit recipients pay tax on an additional dollar of labor or capital income, and thus it does not change incentives to work or save since it does not change the after-tax return to labor or saving. The reason for this is that the credit reaches its maximum value at earnings of $12,903 for married taxpayers filing jointly and only $6,452 for other taxpayers, providing no further incentive to work if one's earnings already exceed those levels, which is the case for the vast majority of recipients of the credit.

Prior Action

No prior action.

B. Increase in the Earned Income Tax Credit

Present Law

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income[88] up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,100 (for 2009). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive a portion of the credit in their paychecks, rather than waiting to claim a refund on their tax returns filed by April 15 of the following year.

Filing status

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year shall not be considered as married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,[89]

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[88] Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

[89] A foster child must reside with the taxpayer for the entire taxable year.

and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, and one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.[90]

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $5,970, resulting in a maximum credit of $457 for 2009. The maximum is available for those with incomes between $5,970 and $7,470 ($12,470 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above $7,470 ($12,470 if married filing jointly) resulting in a $0 credit at $13,440 of earnings ($18,440 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2009 of 34 percent of their earnings up to $8,950, resulting in a maximum credit of $3,043. The maximum credit is available for those with earnings between $8,950 and $16,420 ($21,420 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings above $16,420 ($21,420 if married filing jointly). The credit is completely phased out at $35,463 of earnings ($40,463 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2009 of 40 percent of earnings up to $12,570, resulting in a maximum credit of $5,028. The maximum credit is available for those with earnings between $12,570 and $16,420 ($21,420 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $16,420 ($21,420 if married filing jointly). The credit is completely phased out at $40,295 of earnings ($45,295 if married filing jointly).

A temporary provision enacted in ARRA allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2009 and 2010. For example, in 2009 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $12,570, resulting in a maximum credit of $5,656.50. The maximum credit is available for those with earnings between $12,570 and $16,420 ($21,420 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above $16,420 ($21,420 if married filing jointly). The credit is completely phased out at $43,279 of earnings ($48,279 if married filing jointly).

The phaseout thresholds for married couples were raised to an amount $5,000 above that for other filers for 2009 and 2010 (indexed from the 2009 level of $5,000) under a provision of ARRA. Formerly, the phaseout thresholds for married couples were $3,000 (indexed for inflation from 2008) greater than those for other filers.

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[90] All income thresholds are indexed for inflation annually.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

Description of Proposal

The proposal permanently extends the EITC at a rate of 45 percent for three or more qualifying children.

The proposal permanently extends the higher threshold phase-out amounts for married couples filing joint returns enacted as part of ARRA.

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

Analysis

Proponents argue that the EITC is generally structured to provide greater tax benefits to families with more children, and thus they believe it is appropriate to extend the additional benefits that were recently made available on a temporary basis to larger families with three or more children.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. Large marriage penalties exist in the earned income credit, primarily because the ranges of earned income over which the credit is phased in and phased out are not adjusted for marital status (other than the one provision that delays the phaseout of the credit for married taxpayers). Proponents argue that extending the higher phaseout threshhold for married taxpayers filing jointly in order to reduce the marriage penalty for earned income tax credit filers is particularly important for this low-income population, such that credit recipients are not discouraged from marrying on account of the loss or reduction in credit that marriage could entail.

Some opponents may argue that the combined expansions above provide the earned income tax credit to individuals who some may not consider low- or moderate- income taxpayers since eligibility for the credit can extend past $48,000[91] of income.

[91] Median U.S. family income in the U.S. in 2007 was $61,355. See U.S. Census Bureau, *Historical Income Tables - Families*, available at http://www.census.gov/hhes/www/income/histinc/f06AR.html

Prior Action

No prior action.

C. Increase of Refundable Portion of the Child Credit

Present Law

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

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

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). Prior to the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the threshold dollar amount was $12,550 (for 2009), and is indexed for inflation. Under the ARRA, the threshold amount (beginning in 2009 and 2010) is $3,000. After 2010 the pre-ARRA rules shall apply.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit ("EITC").

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

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Description of Proposal

The proposal permanently extends the lower threshold dollar amount ($3,000) for calculation of the refundable child tax credit. Also, the proposal stops indexation for inflation of the $3,000 earnings threshold.[92]

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

Analysis

Proponents argue that the ARRA expansion of the refundable child tax credit helps offset other Federal tax liabilities to reduce the overall tax burden on working families. Opponents question whether the proliferation of refundable credits unnecessarily contributes to the complexity of the tax system. Others have also expressed concern about compliance issues with respect to refundable credits. The earned income tax credit has special rules related to taxpayers who have improperly claimed the credit in prior years, and consideration could be given to similar rules for the refundable child credit.

Prior Action

No prior action.

[92] Under a separate budget proposal, (described in III.C.) for taxable years beginning after December 31, 2010, the $1,000 child tax credit and other changes are permanently extended.

D. Saver's Credit

Present Law

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[93] The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2009, married taxpayers filing joint returns with AGI of $55,500 or less, taxpayers filing head of household returns with AGI of $41,625 or less, and all other taxpayers filing returns with AGI of $27,750 or less are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2009 are provided in Table 6, below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

Table 6.–Credit Rates for Saver's Credit

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0 – $33,000	$0 – $24,750	$0 – $16,500	50 percent
$33,001 – $36,000	$24,751 – $27,000	$16,501 – $18,000	20 percent
$36,001 – $55,500	$27,001 – $41,625	$18,001 – $27,750	10 percent
Over $55,500	Over $41,625	Over $27,750	0 percent

The saver's credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 years old or older, 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: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b)" annuity), an eligible deferred compensation arrangement of a State or local government (a "section 457 plan"), a savings incentive match plan for employees ("SIMPLE"), or a simplified employee pension ("SEP"); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax-sheltered annuity or qualified retirement plan. Under the rules governing these arrangements, an individual's contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount or the individual's compensation that is includible in income. In the case of IRA contributions of a married couple, the combined includible compensation of both spouses may be taken into account. In addition, for purposes of

[93] Sec. 25B(a).

determining the IRA contribution limit, an individual's includible compensation is determined without regard to the exclusion for combat pay.[94] Thus, excluded combat pay received by an individual is treated as includible compensation for purposes of determining the amount that the individual (and the individual's spouse) can contribute to an IRA.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

Description of Proposal

The proposal makes the saver's credit fully refundable and provides for the credit to be deposited automatically in the qualified retirement plan account or IRA to which the eligible individual contributed.

In place of the current 10-percent/20-percent/50-percent credit for qualified retirement savings contributions up to $2,000 per individual, the proposal provides a credit of 50 percent of such contributions up to $500 (of contributions) per individual (indexed annually for inflation beginning in 2011). The income threshold for eligibility is increased to $65,000 for married couples filing jointly, $48,750 for heads of households, and $32,500 for singles and married individuals filing separately, with the amount of savings eligible for the credit phased out at a five-percent rate for AGI exceeding those levels.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

The current law saver's credit is intended to encourage low-income taxpayers to save, but many have criticized its effectiveness.[95] The principal criticisms of the effectiveness of the saver's credit have focused on the low use of the credit, owing to (1) its lack of refundability, (2) the complexity of the credit rate structure combined with taxpayer uncertainty regarding eligibility, (3) lack of awareness of the credit, and (4) the relatively low AGI thresholds for eligibility.

Those who have criticized the complexity of the credit rate structure note that many taxpayers will not know their precise AGI in order to know what their credit rate will be, or even

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[94] Sec. 219(f)(7).

[95] See, for example, Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Savings Incentives For Low- And Moderate- Income Families In The United States: Why Is The Saver's Credit Not More Effective?," *Journal of the European Economic Association*, April - May 2007, 5 (2-3).

to know if they will be eligible for any credit given that the credit amount drops precipitously to zero once the relevant AGI threshold is crossed. Others have observed that, because the credit is non-refundable, and the AGI eligibility thresholds fairly low, many taxpayers simply cannot benefit from the credit as they have no tax liability to offset.[96] By making the credit refundable and raising the income eligibility limits, the proposal is likely to increase utilization of the credit. Also, the revised structure should make it easier for most taxpayers to have a better sense of the amount of credit for which they will be eligible, which could increase use of the credit to the extent that existing uncertainly limits the use of the credit.

While many taxpayers are saving insufficiently for their future needs, some have criticized the saver's credit on the grounds that low-income taxpayers should not necessarily be encouraged to save (for example, a single parent with young children who is eligible for the saver's credit should probably devote available resources to current needs rather than forgoing current consumption in favor of saving).   Some might argue that the public resources devoted to encouraging saving via this credit could be better used to meet unmet current needs of the low-income population in general, or those specifically of the elderly poor who have saved insufficiently for retirement.

As noted above, the President's proposal increases eligibility for the saver's credit by raising the AGI eligibility thresholds and making the credit refundable. As such, the proposal should be more effective at encouraging additional private saving, but at commensurate additional public cost. Additionally, while a payment to save in the form of a tax credit may encourage additional saving, some of the credit will be paid to those who are saving in any case.[97] If the loss in tax revenues (i.e., public dissaving) due to the credit is large relative to net additional private savings that result from the credit, national saving (the sum of private and public saving) might not increase much, or at all.

The present law saver's credit, as well as the proposed credit, condition credit eligibility on AGI. While use of AGI is a common way to limit eligibility based on economic need, consideration could be given to limiting eligibility using a better measure of a taxpayer's ability to save, such as taxable income (which accounts for the presence of dependents, for example). The current use of AGI might result in a disproportionate amount of the credit going to taxpayers with greater ability to save, while use of taxable income might do a better job of identifying taxpayers with more similar ability to save.

Under the proposal, some taxpayers could be made worse off, as the amount of contributions eligible for the credit is reduced to $500 per individual, rather than present law's $2,000 limit. Thus, for example, an individual eligible for the 20 percent credit under present

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[96] See Gary Koenig and Rob Harvey, "Utilization of the Saver's Credit: An Analysis of the First Year," *National Tax Journal* 58 No. 4 (December 2005). They note that, in an analysis of the first year of availability of the credit, 43 percent of taxpayers who claimed the credit at the maximum rate had their credit limited by their tax liability.

[97] Similar criticisms are made of other savings incentives, such as the exclusion from income of contributions to employer-sponsored retirement plans.

law is potentially eligible for a credit of $400 (20 percent of $2,000), while under the proposal the maximum credit is 50 percent of $500, or $250. To the extent that the main purpose of the saver's credit is to encourage small amounts of retirement saving for those who might not otherwise do any saving, such a reorientation of credit resources might be appropriate.

The provision providing for the option to have the credit deposited into the retirement savings account of the taxpayer might also encourage additional saving. However, additional complexities could result for employers if they are required to set up mechanisms to accept the deposit of the tax credit to an employer plan. The administrative costs of such mechanisms may be disproportionately large for small credit amounts.

Prior Action

No prior action.

E. Automatic Enrollment in Individual Retirement Arrangements

Present Law

Contribution limits

In general

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[98] to which both deductible and nondeductible contributions may be made,[99] and Roth IRAs, to which only nondeductible contributions may be made.[100] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable in gross income.

An annual limit applies to contributions to individual retirement arrangements ("IRAs"). The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount ($5,000 for 2009)[101] or the individual's compensation. In the case of a married couple, 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. For this purpose, the aggregate dollar limit is increased by $1,000. Thus for example, if an individual over age 50 contributes $6,000 to a Roth IRA for 2009 ($5,000 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after tax contributions to Roth IRAs generally are subject to AGI limits. 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 AGI for the taxable year over certain indexed levels. In the case of an individual who is an

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[98] Sec. 408.

[99] Sec. 219.

[100] Sec. 408A.

[101] The dollar limit is indexed for inflation.

active participant in an employer-sponsored plan, the AGI phase-out ranges for 2009 are: (1) for single taxpayers, $55,000 to $65,000; (2) for married taxpayers filing joint returns, $89,000 to $109,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an 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 AGI for 2009 between $166,000 and $176,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions, including catch-up contributions. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2009 are: (1) for single taxpayers, $105,000 to $120,000; (2) for married taxpayers filing joint returns, $166,000 to $176,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be kept in completely separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers (except for married taxpayers filing separate returns) with modified AGI of $100,000 or less generally may convert a traditional IRA into a Roth IRA. Under the Tax Increase Prevention and Reconciliation Act of 2005,[102] the $100,000 limit is repealed for taxable years beginning after December 31, 2009.

The amount converted is includible in income as if a withdrawal had been made,[103] except that the early distribution tax (discussed later) does not apply. However, the early distribution tax is recouped if the taxpayer withdraws the amount within five years of the conversion.

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[102] Pub. L. No. 109-222.

[103] A special rule is provided in the case of a rollover in 2010. In such case, unless the taxpayer elects otherwise, the amount includible in income as a result of the conversion is included in income ratably in 2011 and 2012.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.[104] In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.[105]

Excise tax on excess contributions

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.[106] This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.[107] To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

Taxation of distributions from IRAs

Traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis in the contract in the form of nondeductible contributions or rolled over after tax employee contributions. All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

Roth IRAs

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. 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 first 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.

[104] Sec. 408A(d)(6).

[105] Treas. Reg. sec. 1.408A-6.

[106] Sec. 4973(b) and (f).

[107] Sec. 408(d)(4).

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includable in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions. 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 (including contributions rolled over from other Roth IRAs); (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. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

Early distribution tax

Early withdrawals from an IRA generally are subject to an additional tax.[108] This additional tax applies to distributions from both traditional and Roth IRAs. The tax is calculated by reference to the amount of the distribution that is includable in AGI.[109] Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent tax unless another exception applies. Other exceptions include for withdrawals: due to death or disability; made in the form of certain periodic payments; used to pay medical expenses in excess of 7.5 percent of AGI; used to purchase health insurance for certain unemployed individuals; used for higher education expenses; used for first-time homebuyer expenses of up to $10,000; or made to a member of a reserve unit called to active duty for 180 days or longer.

Deemed IRAs

Certain types of employer-sponsored retirement plans are essentially allowed to provide IRAs to employees as a part of the employer-sponsored retirement plan. This option is available to tax qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA.[110] Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require

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[108] Sec. 72(t).

[109] Because distributions from Roth IRAs attributable to contributions (includible conversion contributions) are not includible in gross income and distributions from all Roth IRAs are treated as first attributable to contributions, the early-distribution tax generally will only apply to a distribution from a Roth IRA when only amounts attributable to earnings remain in all Roth IRAs. However, as noted earlier, a special rule applies for withdrawals within five years of a conversion.

[110] Sec. 408(q).

that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.[111]

Payroll deduction IRA

Under current law, an employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997, Congress indicated that "employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs."[112] Congress encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs."[113] In response to that directive, the IRS published Announcement 99-2,[114] which reminds employers of the availability of this option for their employees.

In 1975, the Department of Labor ("DOL") issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to the Employee Retirement Income Security Act ("ERISA").[115] Interpretive Bulletin 99-1[116] restated and updated the DOL's positions on these programs. Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.[117]

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[111] Treas. Reg. sec. 1.408(q)-1.

[112] Pub. L. No. 105-34.

[113] H. Rep. No. 102-220, at 775 (1997).

[114] 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

[115] Labor Reg. sec. 2510.3-2(d).

[116] 64 F.R. 32999, June 18, 1999; Labor Reg. sec. 2509.99-1.

[117] Labor Reg. sec. 2509.99-1.

Employer retirement plans using IRAs

SIMPLE IRA plan

Under present law, a small business that employs fewer than 100 employees who earned $5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE retirement plan is generally a plan under which contributions are made to an individual retirement arrangement for each employee (a "SIMPLE IRA").[118] A SIMPLE retirement plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of $11,500 (for 2009). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE retirement plan up to a limit of $2,500 (for 2009).

In the case of a SIMPLE retirement plan, 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 retirement plan is not subject to the nondiscrimination rules generally applicable to tax qualified retirement plans.

Employer contributions to a SIMPLE IRA 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. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation); however, a lower percentage cannot be elected for more than two years out of any five year period.[119] Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation 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.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE retirement plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.[120]

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[118] There is also an option to provide a SIMPLE plan as part of a section 401(k) plan (a "SIMPLE section 401(k)" plan). 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 under section 410(b). 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.

[119] This option is not available for SIMPLE section 401(k) plans.

[120] Notice 98-4, 1998-1 C.B. 269.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE retirement plan, and the employer may not maintain any other qualified retirement plan.

Simplified employee pensions

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to tax qualified defined contribution plans ($49,000 for 2009). All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $550 (for 2009) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of SIMPLE retirement 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 ($15,500 for 2008). 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 $5,500 (for 2009).

Automatic enrollment

Under a section 401(k) plan, employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as "elective deferrals" or "elective contributions." A section 401(k) plan may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make contributions to the section 401(k) plan. Alternatively, a plan may provide that elective contributions are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (i.e., affirmatively elects not to make contributions or to make contributions at a different rate). Arrangements that operate in the second manner are sometimes referred to as "automatic enrollment" plans.

In a section 401(k) plan, the employee must have an effective opportunity to elect to receive cash in lieu of contributions. Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.[121]

[121] Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

Pension Protection Act of 2006

The Pension Protection Act of 2006 ("PPA")[122] added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans as well as section 403(b) plans and section 457(b) plans. Use of any of the special rules is predicated on a default contribution that is a stated percentage of compensation which applies uniformly to all participants. In addition, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment, and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.

PPA also made changes to ERISA to permit the DOL to provide a safe harbor default investment option and to preempt State laws if certain requirements are satisfied.[123] Specifically, PPA amended ERISA to provide that a participant in an individual account plan with automatic enrollment is treated as exercising control over the assets which in the absence of an investment election are invested in accordance with regulations prescribed by the Secretary of Labor.

Under the DOL's PPA regulations, which were issued October 24, 2007, the default investment option for those automatically enrolled must be a qualified default investment alternative ("QDIA").[124] The choices for a QDIA include: (1) a product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund); (2) an investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally-managed account); (3) a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and (4) a capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax). In addition, a QDIA must be managed by an investment manager, plan trustee, plan sponsor, a committee comprised primarily of employees of the plan sponsor that is a named fiduciary, or an investment company registered under the Investment Company Act of 1940. Further, a QDIA generally may not invest participant contributions in employer securities.

Tax credit for small employer plan pension start-up costs

Present law provides for a tax credit under section 45E for small employer plan pension start-up costs for the first three years of the plan. The credit is limited to the lesser of $500 per year or 50 percent of the start-up costs.

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[122] Pub. L. No. 109-280.

[123] Sec. 514 of ERISA.

[124] Labor Reg. sec. 2550.404c-5.

Description of Proposal

Automatic payroll deduction IRA program

Under the proposal, employers that have been in existence for at least two years, have 10 or more employees, and do not sponsor a qualified retirement plan for their employees would be required to offer an automatic enrollment payroll deduction IRA program to their employees ("automatic payroll deduction IRA program"). If an employer sponsors a retirement plan, but excludes certain employees (other than excludable employees[125]) under the plan, the otherwise non-excludable employees must be offered the opportunity to participate in an automatic payroll deduction IRA program.

Employers offering an automatic payroll deduction IRA program would give employees a standard notice and election form informing them of the automatic payroll deduction IRA option and allowing them to elect to participate or to opt-out. For any employee who fails to make an affirmative election under the payroll deduction IRA program, the proposal includes a default under which payroll deduction contributions for the employee automatically begin to be made to an IRA established for the employee. Under the proposal, the automatic enrollment contribution rate for employees who fail to make an affirmative election would be three percent of compensation (but not more than the IRA dollar limit for the year). Employees could opt for a lower or higher contribution rate up to the IRA dollar limit for the year.

Employers making automatic payroll deduction IRAs available would not be responsible for opening IRAs for employees or for choosing or arranging default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed. Because this is a new type of employer sponsored retirement plan, the proposal generally does not involve employer contributions, employer compliance with plan qualification requirements, or employer liability under ERISA. A national web site would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Under the proposal, the default under an automatic payroll deduction IRA program may be either a traditional IRA or a Roth IRA. The proposal also specifies a number of administrative requirements that must be satisfied, including a mandated notice of the right to opt out or contribute a different amount, an election period, and specific timing requirements for the employer to make contributions. However, administrative rules would be designed to minimize administrative costs. An excise tax, equal to $100 for each participant to whom the failure relates, applies to the failure of any employer to satisfy the automatic IRA requirements for any year.

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[125] Under the proposal, excludable employees are employees excluded from a qualified employer plan pursuant to section 410(b)(3) (allowing exclusion of nonresident aliens and certain employees included in a unit of employees covered by a collective bargaining agreement) or to section 410(b)(4) (allowing exclusion of employees under 21 or having less than one year of service).

Tax credit for automatic payroll deduction IRA program start-up costs

The proposal provides a tax credit for employers for the first two years in which the employer maintains an automatic payroll deduction IRA program. The amount of the credit is equal to $25 multiplied by the number of applicable employees for whom contributions are made, not to exceed $250 for the year.

Effective date.−The proposal is effective starting January 1, 2012.

Analysis

In general

Advocates of this proposal argue that the proposal will promote retirement savings by employees who do not have access to an employer sponsored retirement plan. Advocates point out that the use of automatic enrollment has increased employee participation in section 401(k) plans because providing contributions to the employee's account under the section 401(k) plan rather than cash in the employee's paycheck as a default takes advantage of the inertia of employees who fail to take action and simplifies the process for employees by eliminating the need for employees to make decisions as to the rate of contribution or the investment of the contributions.[126] They argue that this same inertia will increase saving in IRAs if employers are required to automatically enroll employees in payroll deduction IRAs. In addition, employees would not need to make a decision as to the financial institution at which to establish an IRA or whether to contribute to a Roth or traditional IRA. Advocates for the proposal also argue that an employer mandate for automatic IRAs will involve little cost to employers because the employer is merely a conduit for the IRA contribution, similar to direct deposit of an employee's paycheck to the employee's bank account.[127]

Potential employee behavior

In addition to producing a general increase in participation comparable to that associated with automatic enrollment in section 401(k) plans, advocates for the proposal believe that mandatory automatic payroll deduction IRAs can be expected to increase contributions to IRAs

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[126] James J. Choi; David Laibson; Brigitte C. Madrian and Andrew Metrick; "For Better or Worse: Default Effects and 401(k) Savings Behavior," NBER Working Paper No. W8651. The authors studied three firms that adopted automatic enrollment in their section 401(k) plan. They comment on the effect as follows at 5. "We find that automatic enrollment has a dramatic effect on participation rates. Under automatic enrollment, 401(k) participation rates exceed 85 percent in all three companies regardless of the tenure of the employee. Prior to auto enrollment, 401(k) participation rate ranged from 26-43 percent after six months of tenure at these three firms and from 57-69 percent after three years of tenure."

[127] J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs" at 49, Peter Orszag, J. Mark Iwry, and William G. Gale, ed. *Aging Gracefully: Ideas to Improve Retirement Security in America*, The Century Foundation Press, New York (2006).

by low-income and middle-income employees.[128] They believe that, once these employees actually begin the "habit" of retirement savings, they are likely to continue to make contributions. The theory is that to the extent that these employees are not saving for retirement due to inertia (simple failure to take initiative), that same failure to take initiative may prevent them from electing out of the automatic contributions. By requiring an affirmative decision not to save in order to stop the contributions, advocates argue the proposal, at a minimum, would force employees to think about retirement savings. In the case of employees who can and want to save for retirement, the proposal will assist them in that effort. Advocates also point out that the use of payroll deduction means the individual is not required to come up with a substantial amount of liquidity at a single time to meet minimum deposit requirements imposed by many financial institutions offering IRAs. However, many financial institutions require no more than $500 to open an IRA which is not necessarily substantial. This requirement could be satisfied if an individual saves $40 a month during the year and then opens the account with this savings.

Others point out that there is also evidence that lower-income and middle-income employees who do not opt out of contributing are the most likely to remain at the default rate rather than electing a higher contributions rate.[129] Advocates respond that proposed changes to the Savers Credit, which provide for a fully refundable credit to be deposited automatically in certain retirement accounts, including IRAs, may work in conjunction with the proposal to increase participation by low-income and middle-income individuals. They also point out that many who remain at the default rate might not have elected to participate at all without the automatic feature.

Nevertheless, some argue that certain employees currently do not save for retirement because they need all their income to meet their basic needs, or retirement savings may be trumped by savings, or repayment of loans, for other purposes, such as the purchase of a home or a durable good (e.g. automobile). They also argue that other employees may choose to spend their current income to finance a lifestyle that they wish to maintain. They point out that an automatic IRA may not change this behavior, especially to the extent that it is easy for an individual to opt out of participation.[130] Opting out may be particularly likely in the case of individuals who are already in a negative savings position.

Some argue that automatic enrollment in payroll deduction IRAs is not likely to raise the same employee liquidity concerns that are associated with automatic enrollment in section

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[128] Choi, Laibson, Madrian, and Metric, at 22 found that "automatic enrollment [in section 401(k) plans] does increase wealth accumulation in the lower tail of the wealth distribution by dramatically reducing the fraction of employees that do not participate in the 401(k) plan."

[129] Choi, Laibson, Madrian, and Metric, at 22 found that "relative to employees in the top third of the pay distribution, employees in the bottom and middle of the pay distribution are much more likely to at the default."

[130] This opt out may not be as likely as one might expect. In James J. Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," Edward J. McCaffery and Joel Slemrod, *Behavioral Public Finance,* Ed.. Russell Sage Foundation, 2006, 304-351, the authors found that, before automatic enrollment 1.9 to 2.6 percent of employees who enrolled drop enrollment in a 12 month period, but the increased rate of dropping for a plan with automatic enrollment was only 0.3 to 0.6 percentage points higher than that for a plan without automatic enrollment.

401(k) plans due to the distribution restrictions under section 401(k) plans,[131] making it less likely that employees will elect out of automatic enrollment under a payroll deduction IRA program. For example, contributions to an IRA for a year are permitted to be withdrawn from an IRA (with allocable income) without tax consequence until the individual's due date for filing the income tax return for the year.[132] Even after that the deadline, amounts can be withdrawn, although the early distribution tax may apply for distributions before age 59½. In addition, unlike section 401(k) plan contributions, a payroll deduction contribution to a traditional IRA is deductible without regard to the timing of the election to make the contribution.

Some argue that the ultimate success of an automatic payroll deduction IRA program is not only how much money employees contribute to IRAs through the program, but how much is retained as savings for use in retirement. Others point out that there may be social benefits from pure savings. National savings may increase as a result; individuals can be prepared for unanticipated expenses or changes in their financial situation, such as a job loss. However, national saving does not necessarily increase under the proposal to the extent that other planned saving is diverted into the automatic IRA. Others point out that savings alone do not provide for a secure retirement if the savings are not retained for consumption during retirement.

Historically, there have been significant withdrawals over time from IRAs, as reflected in the distributions made that are subject to the early distribution tax. These withdrawals do not include distributions made pursuant to an exception to the tax. Opponents of the proposal argue that those forced to save through the inertia of automatic enrollment may be more likely to take distributions even if they are required to pay the 10 percent additional tax. Others respond that a counter balance against withdrawal from an IRA, in contrast to withdrawal from a section 401(k) account, is that there is no natural withdrawal event, such as termination from employment, which is likely to precipitate a withdrawal. Thus, inertia also may help keep the funds in the IRA.

Potential employer behavior

Some argue that the success of the program may depend, at least in part, on how it is received by employers. The employers that would be required to establish an automatic IRA program are generally employers that do not currently sponsor any retirement plan for their employees.

Advocates for the proposal argue that, for some employers, the failure to offer a plan may be the result of the same inertia that causes employees to fail to set up an IRA. They further argue that other employers may desire to establish a plan, but do not because of administrative cost or potential liability issues. For these employers, a mandated program may facilitate action that they already wanted to take. Advocates are optimistic that such participation may introduce

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[131] Sec 401(k)(2) provides that distributions from a section 401(k) plan are generally only permitted after the employee attains age 59 1/2 (or after death, disability, or plan termination severance from employment, if earlier). Elective contributions to a section 401(k) plan may be distributed on account of hardship.

[132] This unwind of contributions is permitted under section 408(d)(4).

these employers to retirement plan service providers who may in turn induce them to set up an employer-sponsored retirement plan, such as a SIMPLE IRA plan or a section 401(k) plan.[133] In addition, not everyone agrees with the argument that there will be little cost to employers. Some view the cost as being potentially significant. The ultimate cost to employers will likely depend on how the proposal is designed.[134] While the cost may be less significant than the cost associated with qualified employer plans, administrative costs and issues will be relevant in the establishment of an automatic IRA program. An employer will need to take action to establish a program. The employer will need to have a procedure for establishing default IRAs for employees and may need to decide whether the default should be a traditional or a Roth IRA. Employers must institute notice procedures to inform employees that automatic enrollment will occur absent their affirmative election. In addition, the employer must have resources to address employee concerns and questions about the program. In response to these arguments, the proposal is designed to minimize these administrative costs but will not eliminate them entirely. It does provide a tax credit with a maximum of $250 for the first two years for small employers to reduce this cost.

Advocates of the proposal recognize that the success of the program depends on streamlining compliance requirements for employers so that the cost of compliance is relatively low, and that success may depend on the implementation of the program by the Internal Revenue Service or other responsible agency. Advocates argue that the proposal is designed to be as administratively streamlined as possible, including a provision under which employers will not be required to open IRAs on behalf of employees. They point out that the proposal indicates that a low-cost standard default investment will be provided, which will help to lower employer cost of administration because the employer will not need to select a default investment and the employer's potential liability for a poor choice will be limited.

Opponents argue that some employers may have made a conscious decision not to maintain an employer sponsored retirement plan for their employees. Under current law, other than withholding and paying payroll taxes to fund social security benefits, sponsorship of a retirement plan by an employer is voluntary. Opponents argue that the low level of voluntary establishment of payroll deduction IRA programs by employers who do not sponsor qualified retirement plans is not entirely due to inertia. Some argue that certain employers may have considered and rejected the idea of establishing a payroll deduction IRA program. An employer might have made a judgment that further payroll deductions of any kind, let alone an automatic

[133] J. Mark Iwry and David C. John, at 71.

[134] Mary M. Schmitt and Judy Xanthopoulos, "Automatic IRAs: Are They Administratively Feasible, What are the Costs to Employers and the Federal Government, and Will They Increase Retirement Savings," Preliminary Report Prepared for AARP, Optimal Strategies, LLC, (March 8, 2007), 13. The report indicates that, in addition to cost to employers, costs associated with automatic IRAs to individual participants may erode the accounts significantly. However, in Mary M. Schmitt and Judy Xanthopoulos, "Administering Automatic IRAs," Report Prepared for AARP, Optimal Strategies, LLC, (October 17, 2007), the authors discuss how the costs can be reduced depending on how the proposal is implemented. In Mary M. Schmitt and Judy Xanthopoulos, "Most Small Employers Face Low Costs to Implement Automatic IRAs," Optimal Strategies, LLC (June 24, 2009), the authors point out that automatic payroll systems would reduce cost of automatic IRAs and that most small employers now use automated payroll systems.

program, is not a program that their employees, particularly minimum wage employees, would value. The employer might assume that these employees will not be able to afford any further reduction in take-home pay.

Some argue that the mandatory element of the proposal might generate resentment by certain employers and resistance to embracing the program as a benefit for their employees. They argue that the level of compliance among these employers may depend on the level of enforcement by the IRS. They further point out that an employer could present the option to employees in a way that is more likely to generate an election not to contribute than an election to make contributions.

Financial institutions

In the absence of a proposal that mandates a Federal or State program to accommodate the new small IRAs that will be established, some argue that the financial community would need to embrace the program to make it feasible. Many of the employees who elect, or default into, participation will have no preexisting IRAs. Some will have no current relationship with any financial service provider. For low-income and middle-income employees, the initial contributions will be very small. For example, three percent of weekly pay of $500 is only $15. Most financial institutions charge small annual fees for IRA maintenance and[135] many require minimum contributions to establish an IRA. These fees and minimums may be a significant barrier to making default IRA attractive to low-income or even middle-income taxpayers. Thus, even advocates of the proposal recognize that providing low cost options as suggested in the proposal may be a critical element in a successful program.

Paternalism

The proposal makes mandatory an option that is already available under present law. Individuals are free to contribute to IRAs, subject to certain qualifications, and employers are free to establish payroll deduction IRAs. Employers may even be able to enroll employees in payroll deduction IRAs automatically under PPA changes to ERISA.[136] However, the proposal simplifies some of these opportunities. Proponents have expressed the belief that targeted individuals save insufficiently for retirement despite these opportunities. By mandating automatic enrollment, proponents hope to increase the take up rate of IRAs among the targeted employees in a way that they believe will improve their well being. Some make a case for paternalistic intervention on the grounds that individuals do not act in their own best interest because of limits on individual rationality, a lack of information, or inertia.[137] Some argue that setting the default rule to contribute to an IRA with the ability to opt out, as opposed to the

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[135] *Ibid,* at 44. The report discusses the problem of small automatic IRA contributions including current minimum monthly contributions and annual administrative fees. The report suggests pooling of automatic contributions to reduce administrative fees with respect to automatic accounts.

[136] Under present law, this level of employer involvement may constitute an endorsement of the default IRA and cause the automatic payroll deduction IRA program to be a pension plan under ERISA.

[137] H. Rep. 109-232 Part 1 that accompanied H.R. 2830 (September 22, 2005), at 280.

default rule being nonparticipation with the option of affirmative action to contribute, may be viewed as an example of soft, or libertarian, paternalism.[138] Advocates define paternalism as choosing a policy with the goal of influencing the choices of affected parties in a way that will make those parties better off, and such paternalism is libertarian if no coercion is involved. Others would argue that only voluntarily entered rules are free from coercion.[139] One might view the desirability of a policy differently, or hold it to a higher standard to judge its desirability, if coercion is involved. Some argue that "flaws in human cognition," such as those identified above, "should make us more, not less, wary about trusting government decisionmaking" and that while "soft paternalism is less damaging than hard paternalism….[, s]oft paternalism is neither innocuous or obviously benign."[140]

Protection of employees against employer retaining deducted contributions

The DOL has found numerous instances where employers have deducted amounts from an employee's pay for contribution to a section 401(k) plan but failed to contribute the amount to the plan.[141] In the case of a section 401(k) plan, such failure can result in excise taxes, civil penalties, and even criminal prosecution.[142] The DOL has found that the employee may not be aware that the contributions are not being made until the employee receives his or her account statement.[143] As a result, some argue that it is important that any proposal include comparable protection for employees to those provided to participants under a section 401(k) plan against

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[138] See Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," *American Economic Review Papers and Proceedings*, 93, May 2003, pp. 175-179.

[139] See Daniel B. Klein, "Statist Quo Bias," *Econ Journal Watch*, 1(2), August 2004, pp. 260-271, Cass R. Sunstein "Response to Klein," *Econ Journal Watch*, 1(2), August 2004, pp. 272-273, and Daniel B. Klein, "Reply to Sunstein," *Econ Journal Watch*, 1(2), August 2004, pp. 274-276.

[140] Edward L. Glaeser, "Paternalism and Psychology," *University of Chicago Law Review*, 73, (2006), pp. 133-156, at 133, 135.

[141] Since 1995, the DOL has emphasized 401(k) abuse as a national enforcement initiative. The DOL reports the following 401(k) enforcement initiative results for fiscal years 2007 and 2008: for fiscal year 2008, a total of 1,232 civil investigations were closed, with 1,072 corrected violations and monetary results of $24,863,198 nationwide; for fiscal year 2007, 1,326 civil and criminal investigations were closed with 1,133 corrected violations and monetary results of $51,294,250 nationwide. Fact Sheet: Retirement Security Initiatives, U.S. Department of Labor, Employee Benefits Security Administration, http://www.dol.gov/ebsa/erisa_enforcement.html#section6.

[142] Under DOL Reg. sec. 2510.3-102, an amount withheld from an employee's wages for contribution to a section 401(k) plan becomes part of the assets of the pension plan for purposes of ERISA protections as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. An employer holding these assets after that date commingled with its general assets is engaging in a prohibited use of plan assets under section 406 of ERISA, which generally prohibits a plan fiduciary from engaging in prohibited transactions. The DOL has a correction program that allows employers to voluntarily correct violations under certain circumstances under its Voluntary Fiduciary Correction Program, published in the *Federal Register* on March 28, 2002 (67 FR 15061).

[143] For employees, the DOL includes on its website a list of 10 warning signs that 401(k) contributions are being misused. Examples of the warnings signs listed include the employee's account statement shows a contribution from a paycheck was not made and that the employer has recently experienced severe financial distress (http://www.dol.gov/ebsa/Publications/10warningsigns.html).

these potential abuses by employers. One approach advocated by some is to mandate that all default contributions be made to a government-sponsored IRA and that all employees have a government sponsored IRA as an investment option. They argue that such a requirement could make it easier to establish a mechanism for regularly monitoring whether contributions were being made in a timely manner.

Traditional or Roth IRA as the default

Under the proposal, the default may be either a traditional IRA or a Roth IRA. There is no income limit for nondeductible contributions to a traditional IRA. For deductible contributions, there is no income limit if the taxpayer (or, if married, both taxpayer and spouse) does not participate in an employer sponsored plan. Thus, many argue that an employer is likely to choose a traditional IRA as a default so that higher income employees will not be subject to excise taxes for excess contributions.

However, some argue that, for many taxpayers, a traditional IRA may not be the best choice. Lower income taxpayers may have a lower marginal rate currently than when they receive distributions. In addition, even for individuals who benefit from the deduction (i.e., higher income employees), a contribution to a Roth IRA of the maximum amount (to the extent allowed by the income limits) will produce more income at retirement because a dollar contributed to a Roth account represents greater after-tax savings than a dollar contributed to a traditional deductible IRA. The former is contributed on an after-tax basis while the latter is contributed on a pre-tax basis. Still, higher-income employees may be unable to make regular Roth contributions because of the income limits. In addition, lower income taxpayers making contributions to a Roth IRA are required to include the amount of the contributions in AGI rather than being allowed to deduct it, further diminishing the individual's current after-tax disposal income.

Prior Action

No prior action.

F. Provide the American Opportunity Tax Credit

Present Law

Hope credit

For taxable years beginning before 2009 and after 2010, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,800 (for 2009) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[144] The Hope credit rate is 100 percent on the first $1,200 of qualified tuition and related expenses, and 50 percent on the next $1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phaseout described below) for a $1,200 Hope credit. If a taxpayer incurs $2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a $1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $50,000 and $60,000 ($100,000 and $120,000 for married taxpayers filing a joint return) for 2009. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phaseout ranges are always $10,000 and $20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified

[144] Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2010.

tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

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

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply.[145] The principal EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or

[145] A separate proposal contained in the President's fiscal year 2010 budget permanently extends the changes to the Hope credit made by EGTRRA. See Part II.E of this document for a description of that proposal.

she claimed an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

American Opportunity Tax Credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009 or 2010. The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support, who has at least one living parent and does not file a joint return).

Description of Proposal

The proposal expands the present law Hope credit so as to make permanent the temporary modifications to the Hope credit for taxable years beginning in 2009 and 2010 that are known as the American Opportunity Tax Credit. In addition, the proposal renames the Hope credit the American Opportunity Tax Credit.

The dollar amounts to which the 100-percent and 25-percent credit rates are applied are indexed for inflation, with the amounts rounded down to the next lowest multiple of $100. The AGI phaseout ranges are also indexed for inflation, with the amounts rounded down to the next lowest multiple of $1,000.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

The present-law modifications to the Hope credit, referred to as the American Opportunity Tax Credit, are intended to provide some financial relief to taxpayers faced with increasing tuition costs. The proposal makes the American Opportunity Tax Credit modifications permanent. By increasing the amount of the credit, the phaseout levels, and the number of years of education with respect to which the credit may be claimed, the modifications increase the number of taxpayers who may claim the credit and the amount of credit that those taxpayers may claim. In addition, because the modifications make a portion of the credit refundable, additional people (i.e., those with no Federal income tax liability) may benefit from the credit.

Some people observe that the cost of post-secondary education has increased at a rate in excess of the rate of inflation for nearly 30 years, with the result that it is becoming an ever greater financial burden for individuals to pursue a college education. These people contend that making the American Opportunity Tax Credit permanent will help to mitigate some of this burden. Other people observe that the acquisition of a college degree provides enormous benefits to an individual (e.g., greater lifetime earning potential and increased job opportunities) that are sufficient to justify the cost of acquiring the degree, and that these benefits have increased over time.[146] If the cost of obtaining a college degree were to exceed the resulting benefits, one would expect to see a decrease in the number of individuals pursuing a degree until such time as the costs decrease and/or the benefits increase. As of yet, such a decline in college attendance has not occurred.[147]

Other people argue that some individuals who desire to go to college are unable to do so because they do not have the funds to pay for the education and are unable to borrow the necessary amounts (because, for example, it is difficult to pledge increased future earning potential as security for a loan). For these potential students, a generous government subsidy in the form of the American Opportunity Tax Credit may make up for the deficiency in funding and enable them to pursue the college degree that they desire. In response to this argument, some people observe that there already exist a large variety of programs, available from both the public and private sectors, that are designed to help students to afford college, including various loan programs, merit-based assistance programs, and need-based assistance programs (e.g., the Pell Grant program).

Another aspect of the proposal that merits discussion is that it provides for permanent, partial refundability of the credit. Some argue that credits for education expenses should be refundable to subsidize education for low-income individuals who need the subsidy the most but may have insufficient tax liability to realize the benefit of the Hope credit (without the temporary

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[146] See, e.g., Thomas Lemieux, "Postsecondary Education and Increasing Wage Inequality," *American Economic Review* 96 (May 2006): 195-99.

[147] See Thomas D. Snyder, Sally A. Dillow, and Charlene M. Hoffman, National Center for Education Statistics, U.S. Department of Education, *Digest of Education Statistics 2008* (NCES 2009-020), March 2009, at 269, 296, *available at* http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2009020.

modifications of the American Opportunity Tax Credit). Others argue that refundable tax credits are administratively complex and that there are Federal spending programs, such as the Pell Grant program, that provide direct grants for education to a demographic group of individuals that is generally similar to the group that would be eligible for the permanent, refundable credit.[148] They also argue that the Pell Grant has the advantage of providing its subsidy at the time the education expense is incurred, whereas a refundable credit, unless made advanced-refundable, would provide the subsidy after the education expenses are incurred when the tax return is filed and processed.[149]

Lastly, an issue that affects tax incentives, such as the American Opportunity Tax Credit, as well as direct expenditures to subsidize education, concerns the ultimate economic incidence of the subsidies as compared to the statutory beneficiary. For example, it has been observed that the various individual tax benefits for education (such as the present-law Hope credit) provide incentives for educational institutions to capture some of the benefit by raising their tuition and fees. This observation is particularly true for community colleges that charge less than the amount that is fully subsidized by the Hope credit (e.g., the first $1,200 of tuition in 2008 is eligible for a 100-percent credit for Hope eligible students), because tuition can be raised to $1,200 without the student paying more out of-pocket on an after-tax basis, provided the student or parent has tax liability to offset.[150] Additionally, State and local governments may choose to appropriate fewer funds to the public educational institutions or to financial aid programs in response to the increased support provided by the Federal government via individual tax incentives.[151] These responses by educational institutions and/or State and local governments have the potential to undermine the benefit provided at the Federal level. In particular, to the extent that colleges raise tuition in response to a Federal nonrefundable (or only partially refundable) credit, students or parents without Federal tax liability to offset are unambiguously made worse off.

This last issue of who is the ultimate economic beneficiary of a particular tax benefit for education may be an even greater concern under the American Opportunity Tax Credit and the proposal to make it permanent because this credit provides an even larger subsidy than the

[148] In a separate, nontax proposal, the President's budget proposes to increase the maximum Pell Grant award to $5,550 for the 2010-2011 school year, index the Pell Grant program to the Consumer Price Index plus one percent, and make the Pell Grant program a permanent entitlement (i.e., a mandatory spending program). Office of Management and Budget, *A New Era of Responsibility* (H. Doc. 111-19), at 61 (2009).

[149] The ability to obtain a loan from the educational institution or another source with the expected credit as security would mitigate this concern. However, some people have raised concerns about the high cost of some loans that are made in anticipation of tax refunds.

[150] For students who do not have income tax liability to offset, the college may offer additional scholarship amounts to offset the tuition increase so that these students pay the same out-of-pocket amount as they did before the college attempted to capture the subsidy.

[151] For evidence on the response of educational institutions with respect to tuition policy and governments with respect to appropriations for education, see Bridgett Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It* 101 (Caroline M. Hoxby ed., 2004).

present-law Hope credit. In particular, the American Opportunity Tax Credit increases the amount of tuition that is fully subsidized to $2,000 per year (from $1,200 in 2008). As a result of this change, a college that wishes to capture as much of the subsidy as possible may now have an incentive to raise tuition to at least $2,000. In addition, the American Opportunity Tax Credit substantially raises the income phaseout amounts. Thus, a college that wishes to capture as much of the subsidy as possible now may need to be less concerned that students will be ineligible for the credit (due to their high income) and face increased out-of-pocket costs—the vast majority of Americans have incomes below the new phaseout amounts. Finally, the American Opportunity Tax Credit makes 40 percent of the credit refundable. This change means that a college that wishes to capture as much of the subsidy as possible now may need to be less concerned that students will not benefit from the credit because they have no tax liability. In fact, a college that wishes to leave these students with no increased out-of-pocket costs (e.g., by providing increased scholarship amounts to offset subsidy-capturing tuition increases), may nevertheless be able to capture the refundable portion of the credit.

Prior Action

No similar proposals have been included in recent budget proposals of the President.

IV. REVENUE RAISING PROVISIONS

A. Income of Partners for Performing Services Treated as Ordinary Income

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxable upon the receipt of the partnership interest.[152]

In 1993, the Internal Revenue Service, referring to the results of cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profit interest for services as not a taxable event for the partnership or the partner.[153] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[154] clarifies that this treatment applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[155]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[156] A partnership capital interest for this purpose is an interest that

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[152] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T. C. (1971), *aff'd* 492 F. 2.2d 286 (7th Cir, 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner,* 943 F. 2d. 815 (8th Cir. 1991)).

[153] Rev. Proc. 93-27, 1993-2 C.B. 343, citing the *Diamond* and *Campbell* cases, *supra*.

[154] Rev. Proc. 2001-43 (2001-2 C.B. 191).

[155] A similar result would occur under the 'safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

[156] Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1); see *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert denied*, 380 U.S. 961 (1965).

would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[157]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[158] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[159] The proposed regulations

[157] Rev. Proc. 93-27, 1993-2 C.B. 343.

[158] Sec. 83(h).

[159] 70 Fed. Reg. 29675 (May 24, 2005).

provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also contain a rule that permits a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant) in a partnership, under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[160] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower income tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Amounts distributed to the partner by the partnership are taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Employment tax treatment of partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[161] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[162]

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[160] Sec. 702.

[161] See Chapter 21 of the Code.

[162] Sec. 1401.

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[163] The amount of wages subject to this component is capped at $106,800 for 2009. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[164]

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $106,800 for 2009. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[165] Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[166] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive

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[163] Secs. 3101 and 3111.

[164] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

[165] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[166] Sec. 1402(a)(13).

share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

Description of Proposal

The proposal generally treats net income from any partnership interest as ordinary income if the partner provides personal services, except to the extent income is attributable to the partner's invested capital. Thus, the proposal recharacterizes the service partner's distributive share of income from the partnership, regardless of whether such income would otherwise be treated as capital gain, dividend income, or any other type of income in the hands of the partner. Such income is taxed at ordinary income tax rates and is subject to self-employment tax under the proposal.

To prevent circumvention of the general rule through use of separate entities, the proposal provides that a person who performs services for an entity and holds a disqualified interest in the entity is subject to ordinary income treatment for income and gain with respect to the entity. A disqualified interest includes convertible or contingent debt, an option, or a derivative instrument with respect to the entity.

Effective date.−The proposal generally is effective for taxable years beginning after December 31, 2010.

Analysis

In general

In addressing the merits of treating all service partnership interests as giving rise to ordinary income, several types of issues arise. A fundamental set of issues has to do with the conceptual rightness, or not, of treating partnership income of service providers as ordinary income in the nature of compensation for services. Arguments can be made about whether partnership income should lose its underlying character and be treated as ordinary income (and be subject to employment tax) because the recipient partner contributes labor to the partnership. Another set of issues has to do with the potential complexity, administrability, and appropriate scope of a proposal that applies broadly to all types and sizes of partnerships, raising related concerns about the level of tax sophistication of partners that perform services as well as the costs both to taxpayers and the government of complying with, and enforcing, the rules. In this connection, a related but larger issue is that these income tax concerns would be eliminated by equalization of the tax rates on labor and capital income.

An interest of a service provider in a business is sometimes referred to as a carried interest, particularly as used in specialized businesses such as oil and gas exploration and investment fund management. A carried interest generally is a right to receive a percentage of profits without an obligation to contribute capital to the activity. In the case of a partnership, the carried interest may be structured as a partnership profits interest, under which the partner has a

right to receive a percentage of partnership profits, but has no obligation to contribute capital to the partnership, and has no right to partnership assets on liquidation of the partnership.[167] Under a partnership profits interest, a partner generally does not have an obligation to contribute to the partnership's capital if the partnership experiences losses.

Fundamental tax policy issues relating to carried interests

In general

Historically, labor income of individuals has generally been taxed at ordinary rates, while some forms of capital income[168] have generally been taxed at lower rates.[169] In addition, labor income generally is subject to employment tax (generally 2.9 percent for amounts over $106,800, in 2009). In 2009, for individuals generally, the top rate of tax on capital gain is 15 percent, while the top rate on ordinary income is 35 percent. When the employment tax is added, the top rate on ordinary compensation income in excess of $106,800 is 37.9 percent. This rate differential is thought to be a motivating factor in taxpayers' choice to structure income as a carried interest that can give rise to capital gain rather than as fees or other ordinary compensation income. Carried interests may also be structured to achieve deferral of income compared to alternative structures.

The use of carried interests is not limited to a particular type of business activity,[170] but can extend to any business in which investors desire to align the interests of managers or other

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[167] As income is earned by the partnership but is not yet distributed to the partner with the profits interest, the partner's share of these earnings is credited to his capital account. However, the capital account is debited when the earnings are distributed to the partner. Thus, the partner does not have rights in liquidation of the partnership once his profit share is distributed to him. Alternatively, in the investment fund management business, for example, the assets invested in the fund generally are managed by a group of individuals who contribute a relatively small amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

[168] In general, capital income taxed at lower rates has historically included capital gain. Qualifying dividend income of individuals has been taxed at the same maximum rate as capital gain since 2003. This treatment is scheduled to expire at the end of 2010, as are the current maximum rates for both ordinary income and capital gain. However, during the 1970's, income from services was taxed at a maximum rate of 50 percent while investment income, including dividends, but not including capital gain, was taxed at a higher maximum rate of 70 percent. As an exception to the generalization that capital gains have historically been taxed at a rate lower than labor income, for taxable years beginning in 1988, 1989, and 1990, the maximum tax rates of individuals on all income, ordinary as well as capital gain, was 28 percent.

[169] When labor income and capital income are taxed at the same rates, then issues of the character of income (i.e., whether capital or ordinary) are much less significant. Some distinctions between capital and ordinary income would remain, however, even if the tax rate differential were eliminated. Unlike ordinary income treatment, capital gain treatment entitles investors to tax-free return of basis to the extent of basis in the asset. Another difference between ordinary and capital gain treatment is that capital losses are subject to a limitation on deductibility against ordinary income. Issues of timing (i.e., when income is taxed) are not affected by setting capital and ordinary income rates at the same level.

[170] Recent proposed legislation has addressed the tax treatment of partnership carried interests in the context of the investment fund management business. *See* H.R. 1935, a bill to amend the Internal Revenue Code of 1986 to provide for the treatment of partnership interests held by partners providing services, introduced by Mr.

service providers who contribute labor to the partnership's business with the interests of investors. This is achieved by using positive investment yield as the measure of service providers' income. Under the tax rate structure of present law, with lower rates for capital gains and dividends than for ordinary income, this arrangement may be attractive in businesses whose profits include capital gains and dividends.

Capital income or compensation

The primary question is whether the carried interest is a form of compensation for services, or whether it is more similar to a right to income or gain from capital.

In many cases, it is fairly clear whether money is paid for services rendered, on the one hand, or for the use of capital as equity or debt, on the other hand. This distinction can become more difficult, however, in a business activity involving capital assets and individuals' services with respect to the capital assets. Issues relating to the distinction between gains and earnings from investment in property, on the one hand, and income from the performance of services or from other types of businesses, on the other hand, can be found in many areas. The distinction has been a general source of complexity.[171] Distinctions have been established legislatively for tax purposes in some instances, for example, a self-created copyright, which is treated as property that is not a capital asset.[172]

If the service provider does not contribute capital, but only his labor, the carried interest arrangement involves the performance of services by the individual whose work gives rise to capital income for owners who have contributed capital. While the individual's economic interests are aligned with those of capital investors in the business to the extent that his compensation is based on the positive investment yield of the business, the individual is nevertheless performing services, not receiving a return on contributed capital. Therefore, it is argued that the income should be taxed as ordinary compensation income.

Levin on April 2, 2009 (111th Cong., 1st Sess.). Prior similar legislation passed the House of Representatives on June 20, 2008, in section 201 of H.R. 6275, the Alternative Minimum Tax Relief Act of 2008 (110th Cong., 2d Sess.). An earlier provision was introduced in the House of Representatives on October 25, 2007, by Mr. Rangel as section 1201 of H.R. 3970, the Tax Reduction and Reform Act of 2007, and a similar version passed the House of Representatives on November 9, 2007, as section 611 of H.R. 3996, the Temporary Tax Relief Act of 2007 (110th Cong., 1st Sess.). Previously, a similar provision was introduced on June 22, 2007, as H.R. 2834 in the House of Representatives by Mr. Levin and others (110th Cong., 1st Sess.).

[171] See, e.g., *Comm'r v. Jose Ferrer,* 304 F.2d 125 (2d Cir. 1962), *rev'g* 35 T.C. 617 (1961), involving a disputed distinction between compensation for acting services, on the one hand, and capital gain from the disposition of property rights in the resulting productions, on the other. *See also* Boris I. Bittker and Lawrence Lokken, *Federal Income Taxation of Income, Estates, and Gifts,* Third Edition, 1999, 3-73.

[172] See, e.g., section 1221(a)(3)(A), providing that certain copyrights and other property in the hands of a taxpayer whose personal efforts created the property are not a capital asset and thus are not eligible for capital gain treatment; section 751 (gain on sale of a partnership interest is not capital gain to extent it reflects certain unrealized receivables, including certain rights to payment for services); section 7701(e)(1) (providing for recharacterization of a services contract as a lease in certain situations).

A variety of arguments that such income should not be treated as ordinary compensation have been advanced, principally in the context of the investment management business.[173] For example, it is argued that the service provider with a carried interest is taking economic risk by working in the business and should therefore not be treated as having ordinary compensation income if the income that would flow through the partnership is eligible for capital gains rates. The notion is that capital gains rates are accorded when risk is taken. The risk argument can be criticized, however, in that the capital gains rates apply to the disposition of capital assets, not to risk-taking in general that does not involve capital assets. Further, the capital gains tax rates apply to the disposition of capital assets that have very little risk, such as the sale of U.S. Treasury debt with a yield close to the risk-free rate of return. Moreover, the capital gains tax rates do not apply to many types of income related to risk-taking. For example, capital gains rates do not apply to employee compensation that is performance-based, contingent on meeting sales targets or other performance measures. To the extent that the service provider is risking his time and effort, but not his money, it is argued that the risk rationale for capital gains treatment does not apply.

Another argument made in opposition to the idea of treating income from a carried interest as ordinary income is that the carried interest gives rise to equity, or capital, termed "sweat equity" or "founder's equity." Present law generally treats gain or loss on sale or exchange of an interest in a business in which the seller worked as from the sale or exchange of a capital asset. This is conceptually correct in that a capital asset has been created, it is argued, and by analogy to present-law treatment, income from a carried interest should not be recharacterized. Nevertheless, present law does not treat operating income from a business (for example, from a barber shop, or a widget manufacturing operation) as capital gain to the extent labor contributed to the business creates capital; and the proposal applies to the service provider's share of operating income of a partnership (as well as to gain on disposition of the partnership interest). Furthermore, while the proposal would tax as ordinary income the service provider's share of operating income of the business, the proposal also provides that amounts attributable to invested capital are not recharacterized as ordinary income. Thus, the proposal retains the notion that the service provider's share of capital income from the business, if any, is eligible for capital gains rates.

Separating labor income and capital income

If the service provider contributes capital to the partnership in addition to his labor, it could be argued that teasing apart the capital income and the labor income would be difficult and fact-dependent. This difficulty could make the proposal to tax labor income as ordinary hard to apply and inaccurate in measuring labor income in many cases, perhaps in so many cases as to render the proposal ineffective at taxing labor income as ordinary without changing the treatment of capital income. On the other hand, if other partners have capital interests similar to the

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[173] A discussion of this issue in the context of fund managers and fund investors, with references to related articles, appears in Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. See also the related document, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. These documents are available on the internet at www.jct.gov.

service provider's capital interest, it may not be so difficult to identify the return on the service provider's capital interest in the partnership by reference to the other partners' similar capital interests.

The issue of separating labor income from capital income becomes more complex if capital assets of the business are created by the owner's labor in the business. The business owner working in the business may have an increasingly large interest in capital assets of the business as his labor makes the business grow (the owner's "sweat equity"). It could become quite difficult to identify the portion of operating income of the business that is properly allocable to the individual's labor, and the portion allocable to his interest in business capital.[174] To simplify the analysis, assume the individual performs about the same amount of services in the business every year, and the business grows annually and generates an increasingly large amount of operating income allocable to the service provider's ownership interest.

Should the amount of this operating income that is treated as labor income remain constant because the individual's services remain constant, or should the amount of labor income even grow somewhat as he becomes more experienced and better at the job? Or should the amount of operating income treated as capital income grow in accordance with the growth of the business or the value of the individual's share of the capital assets, even if this results in a reduction or elimination of the amount treated as the individual's labor income (while he is still working at a fairly constant rate)?

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[174] In the context of investment management businesses, this issue has been raised by commentators. *See* New York State Bar Association Tax Section, *Report on Proposed Carried Interest and Fee Deferral Legislation*, Sept. 24, 2008, at 19-52, criticizing the operation of the invested capital rule of section 201 of H.R. 6275; Michael L. Schler, "Taxing Partnership Profits Interests as Compensation Income," *Tax Notes*, May 26, 2008, 829, 846-851, analyzing the invested capital rule of section 611 of H.R. 3996. For other recent commentary, *see* Karen C. Burke, "Back to the Future: Revisiting the ALI's Carried Interest Proposals," *San Diego Legal Studies Paper 09-026*, August 2009; Karen C. Burke, "The Sound and Fury of Carried Interest Reform, *San Diego Legal Studies Paper 09-023*, July 2009; Karen C. Burke, "Fuzzy Math and Carried Interests: Making Two and Twenty Equal 710," *San Diego Legal Studies Paper 09-008*, April 2009; Monte A. Jackel and Robert J Crnkovich, "Partnership Deferred Compensation and Carried Interests," *Tax Notes*, April 20, 2009, 351; Paul Carman, "Taxation of Carried Interests," *Taxes-The Tax Magazine*, March 2009, 111; Mark P. Gergen, "A Pragmatic Case for Taxing an Equity Fund Manager's Profits Share As Compensation," *Taxes-The Tax Magazine*, March 2009, 139; Joel Scharfstein, "Proposed Carried Interest Legislation: The Interaction of Invested Capital and Book-ups," *Taxes-The Tax Magazine*, March 2009, 151; Gregg. D. Polsky, Private Equity Management Fee Conversions," *Tax Notes*, February 9, 2009, 743; Philip F. Postlewaite, "15 and 35: Class Warfare in Subchapter K," *Tax Notes*, January 26, 2009, 503; Howard Abrams, "Carried Interests: The Past Is Prologue," *Emory University Law & Economics Research Paper No. 08-32*, September 2008; Raymond J. Elson and Leonard G. Weld, "Taxation of Private Equity Firms: Good Tax Policy or Just Income Redistribution by Congress?," *Taxes-The Tax Magazine*, September 2008, 35; Douglas A. Kahn, "The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest," 62 *Tax Lawyer*, Fall 2008, 1; Chris William Sanchirico, "The Tax Advantage of Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?," 75 *Chicago Law Review*, 2008, 1071; David A. Weisbach, "The Taxation of Carried Interests in Private Equity, 94 *Virginia Law Review*, 2008, 715; Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," 50 *William & Mary Law Review*, 2008, 115; Carol Kulish Harvey and Eric Lee, "A Technical Walk Through the Carried Interest Provisions Contained in Chairman Rangel's Tax Reform Proposal," *Taxes-The Tax Magazine*, February 2008, 77; Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," 83 *NYU Law Review*, 2008, 1; James H. Lokey, Jr. and Donald E. Rocap, "Selected Tax Issues in Structuring Private Equity Funds, *62 N.Y.U. Institute,* 2004, 509.

Litigation over the issue of reasonable compensation demonstrates that ascertaining the value of personal services is fact-driven and often requires case-by-case analysis, particularly for services of an entrepreneur for which comparables may not be so readily available as for other types of labor.

As an alternative to measuring the labor income, deriving the measure of capital income by comparing other similar capital interests in the partnership may also be difficult in many cases. For example, it is possible that a partnership will not "book up" its assets (i.e., increase the value shown on the partnership's books and records) to reflect the increase in value of the business, for example, if no new partners have been admitted. Thus, it may be difficult to ascertain the relative values of the partnership interests of the service provider and the non-service providing partners. It may be that partners have little or no capital on the books of the partnership, for example, in the situation in which a closely held partnership has borrowed to make distributions, perhaps in an amount exceeding contributed capital. As a result, in these and other fact situations, it is possible that the service partner's interest in partnership capital cannot be readily measured by comparison to other partners' capital interests or even by the more limited yardstick of contributed capital.

Recently introduced legislation proposes rules to implement this concept of measuring service partners' capital by reference to other partners' capital. This legislation generally treats as ordinary income the distributive share of an individual who holds an investment services partnership interest.[175] The legislation includes a provision designed to exclude from ordinary income treatment the income and gain attributable to the partner's qualified capital interest. A qualified capital interest is measured by the amount of contributed capital, amounts included in income on receipt of the partnership interest by virtue of section 83, and the partner's share of partnership income and gain that has not been distributed to him. The bill looks to other similar capital interests of partners that do not provide services to determine whether earnings of the service provider are from a qualified capital interest and therefore not subject to ordinary tax rates by reason of the bill. Advocates may argue that following this model for separating labor income from capital income can work in many situations. On the other hand, it could be said that the capital structure of many partnerships, particularly closely held ones and those in which partners are providing significant services, does not provide classes of partnership interests with similar attributes so that the comparison of the capital interests of the various partners can be straightforwardly analyzed. Thus, the qualified capital interest rules of the recently introduced bill would tend to function more smoothly in the more limited context in which the bill applies − only to investment services partnership interests −, than they would in the broader context of the President's proposal, which is generally applicable to all service partnership interests.

A related question involves whether it is appropriate for the proposal to provide a distinction between income from labor and income from capital upon sale or exchange of the individual's interest in the business at a gain. Present law generally allows capital gain treatment for this type of "sweat equity" on sale or exchange of an interest in a business; such an interest is generally treated as a capital asset.

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[175] H.R. 1935, introduced by Mr. Levin on April 2, 2009 (111th Cong., 1st Sess.), *supra*.

The same sets of questions arise if the business is not successful and generates operating losses and a loss upon sale or exchange of the service performer's interest in the business. Present law generally treats operating income and operating losses of a business as ordinary, so the question as it relates to net operating income primarily involves the employment tax impact of the proposal.[176]

Employment (or self-employment) tax

A corollary issue relates to the employment tax treatment of income received under a carried interest. Because dividends and capital gain are not subject to employment taxes under present law, the desire to avoid employment or self-employment tax, and at higher income levels to avoid the application of the 2.9 percent hospital insurance portion of the tax (which is not subject to an income cap), may motivate taxpayers to structure payments through carried interests. However, to the extent income from carried interests is viewed as labor income, failing to subject these amounts to employment or self-employment tax, while other compensation is subject to such taxes, can lead to economic inefficiency and to distortion.[177]

Issues relating to complexity, administrability, and scope of the proposal

Additional complexity

Characterizing income from carried interests as ordinary compensation income arguably introduces significant additional complexity to the already complex tax law relating to partnerships. The additional complexity arises from the potential need to identify and separate labor income from capital income, to identify comparable capital interests among partners (especially in cases in which the partnership does not have distinct classes of capital interests), and to ascertain and "book up" the value of the partnership in more situations than under present law, for example. The proposal may cause sophisticated taxpayers to engage in tax-motivated restructuring of current and future business arrangements in order to avoid the tax cost of ordinary income treatment to the partner providing services. The additional complexity and the tax-motivated behavioral responses to such a change in the tax rules create inefficiencies and distortions in the economy that reduce overall productivity.

Less sophisticated taxpayers engaged in business in partnership form may unknowingly violate the proposal due to its potential complexity and difficulty of application. For example, in the case of a small business in partnership form whose capital structure does not lend itself to comparison of similar capital interests, the proposal may not function effectively to exclude from ordinary income treatment the income from the service provider's capital interest in the

[176] If the business is a partnership, generally partners are subject to self-employment tax on net income of the business, which takes into account operating losses in determining the amount of net earnings from self-employment.

[177] The inefficiency arises because the taxpayer is motivated to choose the form of business with the highest after-tax return, potentially foregoing the activity or structure with the highest pre-tax return, which would maximize the societal benefit (economic efficiency). In addition, the cost of tax planning to achieve the highest after-tax return can be viewed as distortive, diverting resources away from other productive business activities.

partnership; this analysis could be complex. Thus, the proposal could be criticized as a trap for the unwary in the case of unsophisticated taxpayers.

Nevertheless, the preference for simplicity in the tax law must be balanced with fairness and accuracy of income measurement. The perception that taxpayers with income from different categories of personal services are taxed at disparate rates may increase noncompliance among taxpayers who believe that they are over-taxed or who believe that the tax system is inherently unfair.

Administrability

The proposal could be criticized as likely to require many individual taxpayers to analyze their circumstances and possibly file forms or statements that give rise to little or no change in tax liability. It could also encourage some sophisticated taxpayers to engage in tax planning behavior that gives rise to economic distortions and consumes resources that could be devoted to other productive business activity. On the enforcement side, the proposal may require disproportionate audit resources due to the complex and fact-specific analysis that could be needed to determine compliance. On the other hand, it is possible that administrative guidance or procedures could be developed to minimize the impact of the proposal on taxpayers that are not likely to be subject to it.

Scope of the proposal

The principle of horizontal equity in the tax law (that similarly situated taxpayers should be subject to similar tax burdens) suggests that labor income of all individual taxpayers should be taxed at comparable rates, whether it is earned through a partnership or directly. Thus, the principle of horizontal equity would dictate that the proposal correctly applies to all partners.

Advocates may argue that a safe harbor or carve-out for partnerships considered small enough to be unsophisticated, perhaps based on revenues, asset size, number and wealth of partners, or a combination of these or other factors, could mitigate the impact of the proposal's complexity on small businesses. However, identifying such a threshhold may not be obvious, resulting in potential arbitrariness and either over- or under-inclusiveness. The proposal does not explicitly provide such a carve-out, nor would such a carve-out necessarily be simple in application.

In a similar vein, it may be argued that very few partners outside the asset management business − due to the nature of their business assets and activities − can convert material amounts of labor income to capital gains and dividends, thus lowering the tax rate and avoiding employment and self-employment tax that applies to individuals who earn labor income directly. Most business activities are not so inherently conducive to such conversion and avoidance. Thus, it is argued, it would be preferable to limit the scope of the proposal to businesses involving investment management services,[178] rather than to extend ordinary income and employment tax treatment to service-providing partners in any business. Operating income of

[178] This is the scope of the recent bills cited above.

most businesses is already ordinary income under present law. Thus, as a practical matter, the proposal's effect is to impose self-employment tax on operating income that is already taxed at ordinary income tax rates, and to treat gain on sale or exchange of the partnership interest as ordinary income rather than capital gain.

It may be noted that these income tax issues would disappear or be mooted, including the most basic issue of whether the service partner's income is from labor or capital, if labor income and capital income were taxed under the same rate schedule. If the tax rate schedule were the same for all types of income of individuals, horizontal equity would be satisfied and there would be no income tax impetus for the proposal. In 1986, following enactment of the Tax Reform Act of 1986, the tax rate structure provided the same tax rates for these items, though lower rates for specified income types were added to the law soon thereafter. However, the policy implications of such a rate shift, and the corollary changes that might be necessitated, raise many broader issues than the proper income tax treatment of service-providing partners. Further, the employment (or self-employment) tax issue would not be addressed by equalizing income tax rates.

Prior Action

No prior action.[179]

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[179] A somewhat similar proposal (taxing income of partners performing investment management services as ordinary income) was included in 111th Congress and 110th Congress bills cited above.

B. Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability

Present Law

General structure of the individual income tax

Under the Code, gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include, among other things, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to certain IRAs, one-half of self-employment taxes, certain moving expenses, and alimony payments.

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2009, the amount deductible for each personal exemption is $3,650. This amount is indexed annually for inflation. The deduction for personal exemptions is reduced or eliminated for taxpayers with incomes over certain thresholds, which are indexed annually for inflation. The applicable thresholds for 2009 are $166,800 for single individuals, $250,200 for married individuals filing a joint return and surviving spouses, $199,950 for heads of households, and $125,100 for married individuals filing separate returns. For 2010, the deduction for personal exemptions is not reduced or eliminated based on income.

Standard and itemized deductions

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2009, the amount of the standard deduction is $5,700 for single individuals and married individuals filing separate returns, $8,350 for heads of households, and $11,400 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[180] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation. Finally, a taxpayer may reduce AGI by an additional standard deduction for State and local property taxes paid of $500 ($1,000 for joint filers) and for qualified motor vehicle taxes.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5

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[180] For 2009, the additional amount is $1,100 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,400. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2009) of $2,200 or $2,800, as applicable.

percent of AGI), casualty and theft losses (in excess of $500 per loss and in excess of 10 percent of AGI), and certain miscellaneous expenses (in excess of two percent of AGI).

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's 2009 AGI in excess of $166,800 ($83,400 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present law limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under present law, the otherwise allowable itemized deductions may not be reduced by more than 80 percent. The overall reduction in itemized deductions is phased down to 1/3 of the full reduction amount in 2009 and terminates in 2010. However, the limitation is fully effective again in 2011 and thereafter as a result of the EGTRRA sunset provision.

Individual income tax rates

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains; those rates apply for both the regular tax and the alternative minimum tax.

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2009, the regular individual income tax rate schedules are listed earlier in section III.B of this document.

Alternative minimum tax liability

An alternative minimum tax ("AMT") is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's "tax preference items" and adjusted by redetermining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2009 are: (1) $70,950 in the case of married individuals filing a joint return and surviving spouses; (2) $46,700 in the case of other unmarried

individuals; (3) $35,475 in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions items, are not allowed to reduce AMTI.

Description of Proposal

The proposal limits the rate at which taxpayers with taxable income in excess of a threshold amount benefit from itemized deductions. In general, the proposal limits the benefit of itemized deductions for individuals to 28 percent of the amount of the deductions. The proposal applies to itemized deductions after they have been reduced under a separate fiscal year 2010 budget proposal that would reinstate the pre-EGTRRA limitation on certain itemized deductions, but with adjusted AGI thresholds in 2011 of $250,000 (indexed for inflation from 2009) for married taxpayers filing jointly and $200,000 (indexed for inflation from 2009) for other taxpayers. After 2011, these thresholds will be indexed for inflation.

Example 1: Taxpayer subject to regular income tax

For example, assume that a taxpayer in the 36-percent income tax bracket in 2011 makes a $10,000 charitable contribution. Under present law, the $10,000 contribution will result in a $3,600 tax savings, or 36 percent of $10,000 (disregarding any other limitations that may apply to reduce the taxpayer's itemized deductions). Under the proposal, the same $10,000 contribution by the same 36-percent bracket taxpayer will result in a tax savings of only $2,800 (28 percent of $10,000), thus raising his tax liability by $800 (or eight percent (36 percent minus 28 percent) of his $10,000 contribution).

Example 2: Taxpayer subject to alternative minimum tax

The proposal has two effects on taxpayers subject to the AMT. However, these effects apply only if the taxpayer is first subject to any reduction in his regular tax liability−that is, if his marginal statutory regular tax rate is in excess of 28 percent.

Under the first effect, the proposal increases the taxpayer's tentative minimum tax liability by a fraction of the increase in regular tax liability caused by the limitation. The fraction is equal to the proportion of non-preference item itemized deductions to total itemized deductions. For example, in the example above, assume the taxpayer had $20,000 in State and local taxes, an itemized deduction that is a preference item for purposes of the AMT, in addition

to his $10,000 charitable deduction (a non-preference item), for a total of $30,000 of itemized deductions. Under the regular tax, the taxpayer will have his tax liability increased by eight percent (36 percent minus 28 percent) of $30,000, or $2,400. The taxpayer's tentative minimum tax liability is increased by $2,400 times the fraction of non-preference to total itemized deductions ($10,000/$30,000, or 1/3), or $800.

Under the second effect, if the taxpayer's AMTI is in the range that makes him subject to the phaseout of the AMT exemption amount, the taxpayer is subject to an additional increase in his tentative minimum tax liability. The additional increase is equal to the amount by which the value of the non-preference itemized deductions exceeds 28 percent of the deduction. For example, if the taxpayer is in the 28 percent marginal rate bracket of the AMT, but is also subject to the phaseout of the AMT exemption amount, a non-preference itemized deduction reduces his AMT liability in two ways under present law. First, the direct effect is that the deduction lowers AMTI by the amount of the deduction, reducing the tax liability by 28 percent of the deduction amount. Second, in reducing AMTI directly, the deduction reduces the phaseout of the AMT exemption amount by 25 percent of the deduction amount. Thus the joint effect of the deduction under present law is to reduce AMTI by 125 percent of the deduction, which, for the 28 percent ratepayer, reduces AMT liability by 125 percent of 28 percent, or 35 percent of the deduction amount. Under the proposal, the value of the deduction is limited to 28 percent of the deduction amount, and thus a taxpayer subject to the AMT exemption amount phaseout will face a further increase in his AMT liability, in this case equaling seven percent of the deduction amount.[181] For the taxpayer described above with $10,000 of non-preference deductions, the taxpayer's tentative minimum tax liability is increased a further $700 (seven percent of $10,000).

<u>Effective date</u>.−The proposal is effective for tax years beginning after December 31, 2010.

Analysis

In general

The proposal has been the subject of considerable debate, much of which centers on the likely effect of the proposal on charitable giving and housing (discussed below), although the proposal applies broadly to all itemized deductions. Some proponents have argued that limiting the benefit of itemized deductions in this manner will reduce the incentive to undertake certain activities. Some opponents have argued that such a limitation is inappropriate to the extent that the deductions, such as those for medical expenses, casualty or theft losses, or local taxes, are designed to more accurately reflect a taxpayer's ability to pay. If this is the case, then no adjustment should be made to the deductions, and any concern about fairness or progressivity should be addressed through the marginal tax rate structure.

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[181] In the case of a taxpayer subject to the AMT exemption phaseout but in the statutory 26 percent AMT rate bracket, the value of a non-preference item is 125 percent of 26 percent, or 32.5 percent. Such taxpayer will face an increase in their AMT liability of 4.5 percent (32.5-28) of the amount of the deduction by this second effect of the proposal.

Alternative minimum tax

The proposal impacts taxpayers subject to the AMT more substantially than taxpayers not subject to the AMT. Specifically, the proposal reduces the value of the taxpayer's itemized deductions to an amount less than 28 percent, as a result of the two effects described in example 2 above. Under present law, because the taxpayer's aggregate liability is determined by the AMT (since that yields a higher tax than the regular tax), the taxpayer's regular tax liability is not relevant, so long as it is below his AMT liability. Under the proposal, notwithstanding that the taxpayer is subject to the AMT, an additional increase in AMT liability is imposed based on a regular tax computation that ordinarily would have no bearing on AMT liability. In the example, under present law the taxpayer will receive a $3,500 tax benefit from his $10,000 charitable contribution, composed of the deduction against the 28 percent marginal AMT rate (yielding $2,800) and the reduction in the amount of the phaseout of the exemption amount (25 percent of 10,000 = $2,500), whose value at the 28 percent rate is 28 percent of $2,500, or $700. Under the proposal, the taxpayer loses this $700 benefit related to the phaseout of the exemption amount, and is also subject to the $800 increase in tax based on the first of the AMT effects described above, related to the reduction in the value of the itemized deductions as calculated for the regular tax. On net, the taxpayer thus receives only a $2,000 benefit for the $10,000 deduction; i.e., the value of his charitable deduction is held to 20 percent, not 28 percent.[182]

It is not clear on what grounds the proposal imposes the first of these effects on AMT taxpayers, as the second effect is sufficient to limit the value of the deductions to 28 cents on the dollar. Furthermore, imposing an additional tax liability on taxpayers based on an increase in their regular tax that still leaves their regular tax liability below their AMT liability is a departure from the normal relationship between the regular tax and the AMT. Any tax rule or proposal that increases a taxpayer's regular tax liability could, in a manner parallel to the current proposal, be added to a taxpayer's AMT liability. For example, the limitation in the value of personal exemptions raises a taxpayer's regular tax liability, and the amount by which this limitation raises regular tax liability could be added to AMT liability in like fashion, notwithstanding the normal relationship between the AMT and the regular tax, which is that an increase in one's regular tax liability will increase one's tax liability only if regular tax liability exceeded AMT liability.

Charitable deduction

Some argue that the proposed limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions by increasing the cost (price) of charitable giving.[183]

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[182] In the event that the taxpayer were in the 39.6 percent regular tax bracket but subject to the AMT as well as the phaseout of the AMT exemption amount, the $10,000 charitable deduction will trigger an increase in the AMT of $1,160 by the first effect (39.6 percent - 28 percent times $10,000), and a further $700 by the second effect as described above, yielding a deduction value of only $1,640 ($3,500 - $1,160 -$700). Such taxpayer's charitable contribution deductions are thus limited to 16.4 cents on the dollar, rather than the asserted 28 cents on the dollar.

[183] For a recent literature review of the responsiveness of charitable giving to its price, see John Peloza and Piers Steele, "The Price Elasticities of Charitable Contributions: A Meta Analysis," *Journal of Public Policy & Marketing* 24: 260-272, 2005. See also Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; and Jon Bakija and Bradley Heim "How Does Charitable Giving Respond To

Additionally, the reduction in after-tax income resulting from the proposal will mean that taxpayers have less disposable income to spend on all goods, including charity. Such commentators argue that the proposal therefore will result in a decrease in charitable giving as a result of both the increased price of charitable giving and the reduction in after-tax income.[184] With respect to the altered price of giving, for example, under present law a 39.6-percent bracket taxpayer who makes a $1,000 charitable contribution (disregarding any other limitations that may apply to limit itemized deductions) will save $396 (39.6 percent of $1,000). In other words, the after-tax cost to the taxpayer is only $604 to give $1,000 to charity ($1,000 - $396 savings). Under the proposal, the same $1,000 charitable contribution will cost the same taxpayer $720 ($1,000 - (28 percent of $1,000)). This represents a cost increase of more than 19 percent.

Others, however, argue that the proposed limit will result in little if any reduction in overall charitable giving.[185] Some argue, for example, that charitable giving is motivated in significant part by factors other than tax rules, such as altruism and the overall state of the economy;[186] most taxpayers, therefore will not eliminate or significantly reduce charitable giving under the proposal. Indeed, under the proposal, each additional dollar given to charity by a taxpayer subject to the proposal will continue to result in a tax savings, although at a rate of 28 percent rather than the higher 36- or 39.6-percent rates.

Furthermore, some argue that the proposal improves fairness and equity to the tax treatment of itemized deductions by partially leveling the tax benefit to higher- and lower-income taxpayers resulting from identical gifts. For example, assume that a taxpayer in the 36-percent bracket and a taxpayer in the 25-percent bracket each make identical $1,000 contributions to charity. As a result of the $1,000 contribution, the higher-income taxpayer will have a tax savings of $360 (36 percent of $1,000), such that his cost of making the $1,000 contribution is $640 ($1,000 - $360). The taxpayer in the 25-percent bracket, however, will achieve a tax savings of only $250 (25 percent of $1,000), such that his cost of making the

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Incentives And Income? Dynamic Panel Estimates Accounting For Predictable Changes In Taxation," National Bureau of Economic Research Working Paper 14237, August 2008.

[184] See Independent Sector, Statement on Changes to Tax Incentives for Charitable Giving and Health Care Reform, *http://www.independentsector.org/media/20090326_giving_healthcare_statement.html* (March 26, 2009) (arguing that changes in tax benefits affect charitable giving levels and that the President's budget proposal will result in a decrease in charitable giving).

[185] For example, the Center on Philanthropy at Indiana University performed a study to determine how the President's proposal would affect charitable giving. *See* The Center on Philanthropy at Indiana University, white paper, "How Changes in Tax Rates Might Affect Itemized Charitable Deductions," *available at* http://www.philanthropy.iupui.edu/docs/2009/2009_TaxChangeProposal_WhitePaper.pdf (March 2009) (hereafter "Indiana University White Paper"). Using a simplified model and 2006 itemized deduction data, the Center estimated that, if the budget proposal had been in effect in 2006, "the impact on itemized giving would have been a relatively small reduction when measured as a percentage of total itemized charitable giving by individuals (a decrease of 2.1 percent)." Looking only at the highest income households, the Center estimated a slightly larger drop (approximately 4.8 percent). The Center concluded that "[t]he larger economy plays a more important role in changes in giving than do tax rate changes."

[186] See, e.g., Indiana University White Paper, *supra*.

$1,000 contribution is $750 ($1,000 - $250). In other words, under present law, an identical charitable contribution results in a greater tax benefit (in this example, $110) to the higher-bracket taxpayer, even though the lower-bracket taxpayer arguably has been more generous by contributing a higher percentage of his taxable income to charity. The proposal limits (but does not eliminate) this disparate treatment by limiting the rate at which the higher-bracket taxpayer may benefit from itemized deductions to 28 percent.[187]

On the other hand, such a fairness argument rests on an implicit assumption that, when a taxpayer makes a charitable contribution, he or she is buying something. If, however, one's initial view is that a gift to charity reduces a taxpayer's resources available for private consumption, then the proposed modification to the marginal rates at which taxpayers may benefit from deductions should not be undertaken, lest taxpayers similarly situated with respect to resources available for private consumption would face differential tax burdens.

Mortgage interest and property tax deductions

The deductions for home mortgage interest and property taxes reduce the after-tax cost of financing and maintaining a home. The benefit generally rises as the marginal tax rate of the taxpayer rises. However, research suggests that the benefits of the home mortgage interest deduction, and thus the costs of any limitation, are distributed heterogeneously among taxpayers, even among those with more than $250,000 in income.[188] Within this group, the largest benefits accrue to younger homeowners, who tend to have higher loan-to-value ratios, and to those taxpayers purchasing more expensive homes.

Limiting itemized deductions will raise the after-tax cost of financing and maintaining a home for affected taxpayers. One study estimates that completely repealing the mortgage interest deduction will raise the cost of capital for owner-occupied housing by seven percent.[189] Smaller cost increases are associated with limiting the deduction. However, if taxpayers adjusted their portfolios to reduce their loan-to-value ratios, changing the tax treatment of mortgage interest might have little impact on the user cost.[190] As with the benefits of the

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[187] Note that this disparate treatment would not exist if all taxpayers faced the same marginal tax rate. In other words, the disparate treatment is the joint effect of the deduction and a progressive rate (or any non single rate) structure.

[188] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96, May 2008.

[189] *Ibid.*

[190] See Martin Gervais and Manish Pandey, "Who Cares about Mortgage Interest Deductibility?" *Canadian Public Policy,* vol. 34, March 2008. Wealthier households are more likely to alter their balance sheets to reduce their loan-to-value ratios. To the extent that non-housing assets generate income derived subject to tax, such portfolio shifting will reduce taxable income for these households, partially offsetting the increase in tax due to limitation of the deduction. Indeed, the benefits of deductibility do not increase with income as fast as taxes paid. Accordingly, Gervais and Pandey (2008) find "mortgage interest deductibility makes the tax code less progressive at relatively low levels of income and more progressive for relatively high levels of income."

deduction, the largest increases in the cost of housing will occur for younger, high-income homeowners with relatively higher loan-to-value ratios and relatively fewer non-housing assets with which to reduce those ratios. Demand for housing by affected taxpayers is expected to decline in response to the increased cost.

Some argue that the proposal will have a detrimental effect on the U.S. economy, because it will lead to a decline in home prices at a time when many homeowners have seen the value of their residences decline to an amount below their mortgage balances. Areas with relatively large numbers of affected taxpayers and relatively inelastic housing supply will be expected to face the greatest price declines. This, they argue, could lead to deterioration in bank balance sheets as the value of their mortgage loans and mortgage-backed securities also decline.

Others argue that limiting the home mortgage interest deduction is unlikely to have a detrimental effect on the U.S. economy. They argue that the limitation will affect too few taxpayers to reduce incentives for the marginal homebuyer. Still others question whether the mortgage interest deduction does much to encourage homeownership and thus the positive spillover benefits that might entail.[191] On the contrary, to the extent that the mortgage interest deduction creates economic distortions−increasing the size and cost of housing, increasing the allocation of capital to owner-occupied housing away from potentially higher pre-tax return investments in other sectors, increasing the amount of leverage used to purchase homes−limiting the deduction could be beneficial to the economy as a whole.

Prior Action

No prior action.

[191] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction" in James M. Poterba (ed.), *Tax Policy and the Economy* 17, (Cambridge, Mass.: The MIT Press), 2003.

C. Eliminate Advance Earned Income Tax Credit

Present Law

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income[192] up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax returns filed by April 15 of the following year.

Advance payment system

Under the advance payment system, available since 1979, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year. This means that the taxpayer's paycheck is adjusted to include not only the nonrefundable portion of the EITC (i.e., by reducing otherwise applicable tax liability) but also a portion of the refundable EITC (i.e., an outlay rather than a reduction in otherwise applicable tax liability). The advanceable portion of the EITC is limited to 60 percent of the maximum EITC for one qualifying child. A taxpayer electing the advance payment option is required to file a tax return for the taxable year (regardless of the otherwise applicable filing thresholds) in order to reconcile any advance payment with the actual allowable EITC.

Beginning in 1993, Congress required the IRS to notify eligible taxpayers of the advance payment option, but participation in the advance payment option has remained limited to a small percentage of eligible taxpayers.

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[192] Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

Description of Proposal

The proposal repeals the advance payment option for the EITC. The taxpayer may still receive the nonrefundable portion of the EITC through the taxpayer's paycheck, by adjusting withholding, to the extent the taxpayer otherwise has positive tax liability.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2009.

Analysis

The advanced EITC does not affect the size of the EITC, but only the timing of the payment. Eliminating the advance payment option would not affect the timing of the EITC for most EITC recipients because the vast majority of recipients do not elect it. Eliminating the advance payment option resolves noncompliance problems associated with it, according to proponents of the repeal, and simplifies the tax law for all EITC taxpayers.[193] Opponents of the repeal of the advance payment option argue that this repeal eliminates a useful delivery mechanism for those taxpayers who correctly claim the advance payment option under present law.

Prior Action

No prior action.

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[193] A useful discussion of the compliance issues with the advance EITC system is contained in General Accountability Office report entitled. *Advance Earned Income Tax Credit Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance* GAO-07-1110 August 2007.

V. ESTATE AND GIFT TAX REFORM PROVISIONS

A. Require Consistency in Value for Transfer and Income Tax Purposes

Present Law

The value of an asset for purposes of the estate tax is the fair market value at the time of death or at the alternate valuation date. The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or alternate valuation date, if elected by the executor. Under regulations, the fair market value of the property at the date of the decedent's death (or alternate valuation date) is deemed to be its value as appraised for estate tax purposes.[194] However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir.[195] Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may rebut the use of the estate's valuation as his or her basis by clear and convincing evidence. The heir is free to rebut the presumption in two situations: (1) the heir has not used the estate tax value for tax purposes, the IRS has not relied on the heir's representations, and the statute of limitations on assessments has not barred adjustments; and (2) the heir does not have a special relationship to the estate which imposes a duty of consistency.[196]

For property acquired by gift, the basis of the property in the hands of the donee generally is the same as it was in the hands of the donor. However, for the purpose of determining loss on subsequent sale, the basis of property in the hands of the donee is the lesser of the donor's basis or the fair market value of the property at the time of the gift.[197]

Description of Proposal

The proposal requires that the basis of property received by reason of death under section 1014 generally must equal the value of that property claimed by the decedent's estate for estate tax purposes. The basis of property received by lifetime gift generally must equal the donor's basis determined under section 1015. Under the proposal, the basis in the hands of the recipient can be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments).

In addition to requiring consistency in values for transfer and income tax purposes, the proposal imposes a reporting requirement. The executor of a decedent's estate and the donor of a lifetime gift are required to report to both the recipient and the IRS the information necessary to determine the recipient's basis under the proposal.

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[194] Treas. Reg. sec. 1.1014-3(a).

[195] See Rev. Rul. 54-97, 1954-1 C.B. 113.

[196] See Tech. Adv. Mem. 199933001 (January 7, 1999).

[197] Sec. 1015(a).

The proposal provides for regulatory authority necessary to implement and administer the requirements of the proposal, including establishing rules for: (1) situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503 (e.g., pursuant to the gift tax annual exclusion); (2) situations in which the surviving joint tenant or other recipient may have better information than the executor; and (3) the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

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

Analysis

Providing an heir with fair market value information gives the heir records to improve reporting of income upon future realization of gain. Providing the IRS with the same information would better enable the IRS to challenge attempts to underreport gain upon a subsequent realization of that gain.

Under present law, generally the incentive exists for an executor of an estate or a donor of a lifetime gift to offer low estimates of the value of assets for estate or gift tax purposes. For the purpose of determining gain or loss on an inherited asset or on an asset received by gift, generally the recipient would prefer a higher basis.[198] The government is potentially whipsawed by inconsistent valuations. For example, the IRS has ruled that while value as appraised for estate tax purposes provides a presumptive value for the basis of inherited property in the hands of a beneficiary, such estate tax valuation generally is not conclusive.[199] In a case discussed in a technical advice memorandum,[200] at the time of the decedent's death the taxpayer owned stock in two closely held corporations. On audit, the IRS proposed a higher value for the stock than the value the executor provided on the estate tax return. The estate subsequently argued for a lower valuation and the IRS agreed to an amount in between the two parties' initial valuations. Following a redemption of the inherited stock from the beneficiary, the beneficiary (in an amended return for the taxable year of redemption) claimed a basis in the stock that was higher than both the original estate tax return value and the agreed upon value.

Underlying the rebuttable presumption rule set forth in the technical advice memorandum is the theory that a taxpayer should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination or benefit from it. This theory represents an application of an estoppel principle that is used outside the context of the estate tax. Where, however, a taxpayer

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[198] This preference is especially clear in the case of a spouse of the decedent. That spouse will not, for example, bear the burden of an estate tax on his or her bequest. Other beneficiaries generally will bear the burden of the estate tax and therefore may have competing preferences.

[199] In Rev. Rul. 54-97, 1954-1 C.B. 113, the IRS concluded, "Except where the taxpayer is estopped by his previous actions or statements, such value [the value of the property as determined for estate tax purposes] is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence."

[200] Tech. Adv. Mem. 199933001 (January 7, 1999).

succeeds in presenting clear and convincing evidence of a higher basis than the value used for estate tax purposes, this principle conflicts with one rationale for the section 1014 basis step-up rule. Some analysts argue that the step-up of an asset's basis at death is an appropriate adjustment to prevent property transferred at death from being subject to both Federal income tax and estate tax. If the basis in the hands of the heir exceeds the value used for estate tax purposes, an exemption from income tax in excess of the appreciation in decedent's hands has been created. By helping to ensure consistency in value for estate and income tax purposes, the proposal at least mitigates the whipsawing of the government that may occur under present law.

In general, in the computation of capital gain or loss, establishing basis in property is a problem for taxpayers and the IRS, because the basis in the property becomes important for determining tax liability only when the asset is sold, often many years after the asset is acquired. Taxpayers may lose records in the interim. The difficulty would be particularly acute where the taxpayer did not purchase the asset in question and consequently would have no records (e.g., receipts or other purchase documentation) to begin with. Thus, another rationale for the basis step-up rule of present law section 1014 is to provide administrative simplicity for the heir and the IRS because the heir's fair market value basis will potentially already have been determined for estate tax purposes. The proposal achieves this administrative goal by having basis reported at the time an asset is bequeathed, thereby establishing a record comparable to purchase documentation. Present law arguably fails to achieve this objective, both because the executor is not required to report the estate tax value to the heir, and because the heir is not required in all cases to use such value in determining basis.

Under the proposal there would be instances in which the value of an asset reported by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is artificially low, and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir's basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation, and an heir may sell an asset before the determination of value for estate tax purposes.

By requiring the value of an asset reported for transfer tax purposes to be reported and used by the heir or donee in determining basis, however, the proposal has the salutary effect of encouraging a more realistic value determination in the first instance. This salutary effect would be lost if there were a relief mechanism for transferees and transferors (and recoupment for the government) if the basis used by transferees differed from the fair market value ultimately determined for transfer tax purposes.[201] Thus, the proposal does not contain any such relief mechanism.

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[201] Compare *Ford v. United States,* 276 F.2d 17 (Ct. Cl. 1960) (permitting taxpayers for income tax purposes to use a basis for inherited assets greater than the fair market value reported for estate tax purposes; two dissenting judges argued that the government was entitled to recoupment from the taxpayers for previous underpayment of estate taxes based on a lower property valuation).

Under the proposal, the basis in the hands of the recipient can be no *greater than* the value of that property as determined for estate or gift tax purposes. Where a recipient of a gift or bequest believes the transferor overstated the value of transferred property for transfer tax purposes, it is the understanding of the Joint Committee staff that the proposal would permit the recipient to claim a basis *lower than* the value claimed for transfer tax purposes. This rule likely is designed to protect recipients of gifts and bequests from accuracy-related penalties under section 6662 on a subsequent disposition of property in situations in which the transferor overstated the value of such property for transfer tax purposes.

Prior Action

A similar proposal was included in the President's fiscal year 2000 and 2001 budget proposals.

B. Modify Rules on Transfer Tax Valuation Discounts

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.[202] The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[203]

If actual sales prices and bona fide bid and asked prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook in the nation and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.[204]

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of stock held by a 50-percent shareholder might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts used under present law are discussed below.[205] In many cases courts apply more than one discount. The theories of some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

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[202] Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternate valuation date if the executor so elects) in the case of the estate tax.

[203] Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

[204] Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237.

[205] Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities)* discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely-held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.[206] Minority discounts arise from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.[207]

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests often are less attractive to investors and have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,[208] but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.[209] Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases.

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[206] See Rev. Rul. 93-12, 1993-2 C.B. 202; *Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner,* 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner,* 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

In *Pierre v. Commissioner*, 133 T.C. 2 (2009), the Tax Court allowed minority and marketability discounts in valuing transfers of interests in a single member LLC to trusts established for the transferor's children. The taxpayer had funded the LLC with cash and marketable securities 12 days before she transferred the LLC interests to the trusts. Although the LLC was treated as a disregarded entity for Federal tax purposes under the "check-the-box" regulations, the court rejected the Service's argument that the taxpayer should be treated as having transferred for Federal gift tax purposes a proportionate share of the underlying assets of the LLC and thus should not be entitled to claim valuation discounts. The court reasoned that State law controlled the determination of what property interests were transferred for Federal transfer tax purposes; under State law, the LLC was a separate legal entity, and the taxpayer did not have a property interest in the underlying assets of the LLC. In its opinion, the court noted that "Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically." *Id*.

[207] See David T. Lewis and Andrea Chomakos, The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities (ABA Publishing 2004) at 11.

[208] E.g., *Central Trust Co. v. United States*, 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner*, T.C. Memo 1989-466.

[209] Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

However, the discount has been applied to a 100-percent ownership interest in a closely-held corporation.[210] Marketability discounts often result in reductions in the value of transferred property of 20 to 30 percent[211] in addition to any applicable minority discount.[212] Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts created through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (e.g., a gift of an undivided fractional interest in real estate).[213] Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.[214]

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and

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[210] See, e.g., *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. ("Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.").

[211] There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, i.e., converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

[212] The Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

[213] Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, para. 135.3.4 (2d ed. 1993). Courts, however, often apply a minority discount instead. See, e.g., *LeFrak v. Commissioner*, T.C. Memo 1993-526.

[214] See, e.g., *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

companies. These discounts can be as high as 50 percent and may overlap with the marketability discount.[215]

<u>Special rules regarding restrictions on liquidation (section 2704(b))</u>

Restrictions on the liquidation of an entity (or of an interest in an entity) sometimes serve as the basis for a marketability discount. Where the entity is family-controlled, however, some believe that such restrictions are included in governing documents principally to achieve a reduction in value for transfer tax purposes, but that the claimed reduction in value does not reflect the true economic value of a transferred interest in the hands of the transferee.[216]

To address this concern, section 2704(b) provides that certain "applicable restrictions" are disregarded in determining the value of a transferred interest if the transfer is of an interest in a corporation or partnership to or for the benefit of a member of the transferor's family,[217] and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity.[218] An applicable restriction is a restriction that effectively limits the ability of the entity to liquidate, where (1) the restriction lapses, in whole or in part, after the transfer, or (2) the transferor or any member of the transferor's family, either alone or together, has the right after the transfer to remove, in whole or in part, the restriction.[219] An applicable restriction does not include commercially reasonable restrictions that arise as part of certain third-party financing arrangements, or any restriction imposed, or required to be imposed, by any Federal or State law.[220] Section 2704(b) also grants the Secretary broad regulatory authority to disregard any other restriction that reduces the transfer tax value of an interest but does not reduce the value of such interest to the transferee.[221]

Since the enactment of section 2704(b), new State statutes providing for more restrictive liquidation rights, as well as regulatory and judicial interpretations of section 2704(b), arguably have limited the provision's effectiveness in curbing inappropriate marketability discounts. In its opinion in *Kerr v. Commissioner*,[222] for example, the Tax Court asserted that current Treasury

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[215] For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

[216] See H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1028, 1137-1138 (1990).

[217] For purposes of section 2704, a family member includes, with respect to an individual: (1) a spouse; (2) ancestors and lineal descendants; (3) brothers and sisters; and (4) spouses of an individual described in (2) or (3). Sec. 2704(c)(2).

[218] Sec. 2704(b)(1).

[219] Sec. 2704(b)(2).

[220] Sec. 2704(b)(3).

[221] Sec. 2704(b)(4).

[222] 113 T.C. 449, 472 (1999), *aff'd*. 202 F.3d 490 (5th Cir. 2002).

regulations expand the Code-based exception that excludes from the definition of "applicable restriction" certain State or Federal law liquidation restrictions. Indeed, instead of limiting the exception to restrictions *imposed or required to be imposed* by law (as under the language of section 2704(b)(3)(B)), the regulations provide that "[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) *that is more restrictive than* the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."[223] The IRS generally has been unsuccessful in arguing for a more limited interpretation of this exception in court cases in which the breadth of the exception is at issue.[224]

Description of Proposal

The proposal modifies section 2704(b) to create a category of "disregarded restrictions" that would be ignored when valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. The proposal provides that the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations.

The proposal provides that disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest in the family-controlled entity that are more restrictive than a standard to be specified in regulations. A disregarded restriction also would include a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. In determining whether a restriction may be removed by one or more members of the family after a transfer, certain interests held by charities or others who are not family members would be deemed to be held by the family. Such interests are to be identified in regulations.

Under the proposal, regulatory authority is granted, including the ability to create safe harbors under which the governing documents of a family-controlled entity could be drafted so as to avoid the application of section 2704 if certain standards are met. The proposal includes conforming changes relating to the interaction of the proposal with the transfer tax marital and charitable deductions.

Effective date.−The proposal is effective for transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

Analysis

Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax

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[223] Treas. Reg. sec. 25.2704-2(b) (emphasis added).

[224] See, e.g., *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*. 202 F.3d 490 (5th Cir. 2002); *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001).

purposes do not accurately reflect economic value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.[225]

The proposal seeks to curb the use of family limited partnerships ("FLPs") and LLCs to create valuation discounts, specifically marketability (*i.e.*, liquidity) discounts. The proposal would achieve this goal through a more robust version of section 2704(b), under which taxpayers would be subject to greater limits on marketability discounts arising from liquidation restrictions when transferring interests in family-controlled entities. Specifically, the proposal would create a new class of "disregarded restrictions" that are ignored when valuing such an interest. Disregarded restrictions would include certain liquidation restrictions, as well as a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. The proposal thus seeks to limit the use of a strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death, namely, the inclusion in governing documents of purported restrictions that do not reflect economic reality. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

Some may argue that the proposal does not specify or adequately describe the liquidation restrictions that will be disregarded in valuing a transfer of a family-controlled entity or other key aspects of the proposal; therefore, it is difficult to assess whether the proposal would be effective. As described above, the proposal establishes new "disregarded restrictions" that would be ignored in valuing an interest in a family-controlled entity. The Treasury Department provides that "the transferred interest would be valued by substituting for the disregarded

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[225] Commentators have referred to this discounting as the "disappearing wealth" phenomenon: Wealth disappears from the transfer tax base even though no (or little) actual economic value is lost. See Mary Louise Fellows and William H. Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome," 30 *Stanford Law Review* 895 (1978); James Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 *Tax Law Review* (1995); Laura E. Cunningham, "Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP," 86 *Tax Notes* 1461 (2000).

Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001), provides a simple example of the creation of discounts shortly before death. Mrs. Church, who was the mother of the plaintiff and was suffering from a terminal illness, and her two children together formed a limited partnership. In exchange for limited partnership interests, Mrs. Church contributed to the partnership her interest in a Texas ranch (valued at $380,038) together with $1,087,710 in publicly traded securities, while her two children contributed their undivided interests in the ranch. A corporation owned equally by the two children was the general partner of the partnership. Two days after the formation of the partnership, Mrs. Church died. The District Court found that the date-of-death value of Mrs. Church's limited partnership interest was $617,591, despite the fact that Mrs. Church transferred assets to the partnership worth $1,467,748 just two days earlier. The court upheld a 58-percent discount based upon the noncontrolling and illiquid nature of Mrs. Church's limited partnership interest.

restrictions certain assumptions to be specified in regulations."[226] The proposal, however, does not describe the assumptions that would be specified in regulations. Without such information, it is difficult to determine how the proposal is intended to operate. In addition, the Treasury Department provides that "[d]isregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations."[227] One could speculate that this regulatory standard is intended in part to address interpretive concerns that have arisen regarding the present-law exception for restrictions that are imposed or required to be imposed under State or Federal law. The proposal, however, does not provide information from which one could determine what such a regulatory standard might include or whether such a standard might also be intended to address other concerns.[228]

Some also may argue that, even in the absence of the proposal, the Secretary has broad authority under section 2704(b)(4) to issue new regulations establishing restrictions that must be disregarded in valuing transfers of an interest in a family-controlled entity; the proposal, under which many important details are left to regulations, arguably adds little to this present-law authority. The Tax Court in *Kerr v. Commissioner* stated that it was "mindful that the Secretary has been vested with broad regulatory authority under section 2704(b)(4)," but concluded that the current Treasury regulations did not support the IRS's position in the case.[229] This statement by the *Kerr* court suggests that the court believed that the Secretary already has the authority to issue new, more restrictive regulations under section 2704(b). Furthermore, the IRS and Treasury business plan for 2008-2009 describes a plan to issue guidance under § 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership. The Treasury Department's explicit plan to issue new guidance under section 2704(b) arguably raises questions about whether a legislative modification of this section is premature or even necessary.

Because the proposal targets only marketability discounts arising from liquidation restrictions, some may argue that a broader approach would be preferable. If, for example, an entity whose interests are nonmarketable holds marketable assets, a marketability discount for an interest in the entity results in the undervaluing of the interest if the owner has a controlling interest in the entity and can easily access the marketable assets. Some other proposals have sought to curb this practice by imposing "look through" rules under which a marketability discount generally is denied to the extent an entity holds marketable assets.[230] These proposals

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[226] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (May 2009), p. 121.

[227] *Ibid.*

[228] The Treasury Department also provides that, in determining whether a restriction may be removed by a family member following a transfer, certain interests held by charities or others who are not family members would be deemed to be held by the family; these interests are not described in the proposal, but would be "identified in regulations." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (May 2009), p. 121.

[229] 113 T.C. 449, 474 (1999).

[230] See, e.g., Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 27, 2005), pp. 396-404; Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (February 1999) at 167; Department of the Treasury, *General Explanations of*

would apply even in the absence of liquidation restrictions. If the Administration's fiscal year 2010 budget proposal were enacted, taxpayers might seek to take advantage of marketability discounts through structures that did not depend on liquidation restrictions.

Furthermore, because the proposal targets only marketability discounts, it would not directly address minority discounts that do not accurately reflect the economics of a transfer. Some other proposals have sought to address certain excessive minority discounts more directly through aggregation of certain interests when determining whether a transferred interest in an entity should be valued as a minority interest. In 2005, the staff of the Joint Committee on Taxation published a proposal that includes such aggregation rules. Under the basic aggregation rule of the staff proposal, the value for transfer tax purposes of an asset transferred by a donor or decedent generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor immediately before the transfer.[231] Under a separate aggregation rule included in the proposal, if a donor or decedent did not own a controlling interest in an asset immediately before a transfer, but in the hands of the donee or heir, the transferred asset is part of a controlling interest, the transfer tax value of the transferred interest is a pro-rata share of the fair market value of the entire interest in the asset owned by the donee or heir after taking into account the gift or bequest.

Some other proposals have addressed minority discounts through rules that attribute ownership among family members. For example, one recently introduced bill, the Certain Estate Tax Relief Act of 2009, would deny a minority discount in connection with the transfer of an interest where the transferee and members of the transferee's family together have control of the entity.[232] For purposes of the bill, a member of the family is defined broadly to include, among others, the transferee's ancestors, spouse, lineal descendants, siblings, and spouses of lineal descendants. Although the Administration's budget proposal considers family relationships in determining whether a restriction on liquidation could be removed for purposes of section 2704(b), it does not include a family attribution rule that addresses the inappropriate use of minority discounts where family members control an entity. Some may argue, however, that such a family attribution rule would be inappropriate, because it is not correct to assume that individuals always will cooperate with one another merely because they are related.

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the Administration's Fiscal Year 2001 Revenue Proposals (February 2000) at 184-85; H.R. 436, *Certain Estate Tax Relief Act of 2009* (111th Cong., 1st Sess.).

[231] The basic aggregation rule is similar to a proposal made by the Treasury Department in 1984 as part of a broad report on tax reform. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth, vol. 2, General Explanation of the Treasury Department Proposals* (November 1984) at 386-88. The 1984 proposal, however, based the value of transferred property on the transferor's highest level of ownership after taking into account prior gifts. This tracing of ownership backward through all gifts made by a transferor during his or her lifetime arguably would create administrative difficulties.

[232] H.R. 436, *Certain Estate Tax Relief Act of 2009* (111th Cong., 1st Sess.).

Prior Action

No prior action. Different proposals to reform transfer tax valuation discounts were included in the President's Fiscal Years 2000 and 2001 budget proposals.

C. Require Minimum Term for Grantor Retained Annuity Trusts (GRATs)

Present Law

Overview

Present law provides special rules for valuing certain transfers in trust of temporal interests in property (such as annuity interests and remainder interests).[233] Present law also provides rules for determining when a grantor of a trust will be treated as the owner of all or part of the trust for income tax purposes.[234] Grantor retained annuity trusts (GRATs) and charitable lead trusts (CLTs) are two vehicles, often structured as grantor-owned, that are used to make transfers of temporal interests in property.

Valuation of certain transfers in trust

In the event of a lifetime transfer in trust to (or for the benefit of) a member of the transferor's family where the transferor or an applicable family member retains any interest in the trust, a special rule applies for purposes of determining the value of the transferor's gift.[235] In general, the value of any retained interest that is not a "qualified interest" is treated as zero.[236] Therefore, where a transferor retains an interest that is not a qualified interest, the entire amount transferred to the trust generally is treated as a gift by the transferor to the remainder beneficiaries, which gift is subject to transfer taxation.[237] The value of a retained interest that is a qualified interest, on the other hand, is determined using rates and procedures described in the Code for valuing temporal interests in property.[238]

For these purposes, the term "qualified interest" means: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (i.e., a qualified annuity interest); (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually) (i.e., a qualified unitrust interest); and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2) (i.e., a qualified remainder interest).[239]

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[233] See sec. 2702.

[234] See secs. 671-679.

[235] Sec. 2702(a)(1).

[236] Sec. 2702(a)(2)(A).

[237] The special valuation rule does not apply in certain excepted situations, including: (1) where the transfer is not a completed gift; and (2) transfers to certain personal residence trusts. See sec. 2702(a)(3).

[238] Sec. 2702(a)(2)(B); sec. 7520.

[239] Sec. 2702(b).

A qualified interest is valued under procedures described in section 7520 using tables prescribed by the Secretary of the Treasury and an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the Federal midterm interest rate in effect under section 1274(d)(1) for the month in which the valuation date falls. The tables and rates described in section 7520 assume that the assets in a trust will grow at a relatively modest rate.

"Grantor trust" rules

For income tax purposes, a trust is generally a separate taxpayer. Under certain circumstances, however, a grantor is treated as the owner of all or part of a trust.[240] When a grantor is treated as owner of a trust, the grantor, when computing his or her taxable income and credits, generally must include items of income, deductions, and credits of the trust attributable to the portion of the trust deemed owned by the grantor.[241]

The Code includes a number of rules regarding when a grantor or another person is treated as the owner of all or part of a trust for income tax purposes.[242] A grantor may, for example, be treated as the owner of a trust for income tax purposes where the grantor has: (1) a reversionary interest in the corpus or income of the trust;[243] (2) the power to control beneficial enjoyment of the corpus or income of the trust;[244] (3) certain administrative powers;[245] (4) the power to revoke all or part of the trust;[246] or (5) the power to distribute income to or for the benefit of the grantor.[247]

A trust that is structured such that the grantor is treated as the owner for income tax purposes, but not for gift or estate tax purposes, is sometimes referred to as an "intentionally defective grantor trust."

Grantor retained annuity trusts

A GRAT generally is an irrevocable trust under which the grantor retains an annuity interest structured as a "qualified interest" under section 2702. The annuity interest must be an irrevocable right to receive a fixed amount at least annually.[248] The trustee must be required to

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[240] See secs. 671-679.

[241] See sec. 671.

[242] See secs. 673-677.

[243] Sec. 673.

[244] Sec. 674.

[245] Sec. 675.

[246] Sec. 676.

[247] Sec. 677.

[248] Treas. Reg. sec. 25.2702-3(b).

invade the principal of the trust in the event the income is insufficient to pay the qualified annuity.

Assuming the transfer of assets to the trust is treated as a completed gift for gift tax purposes, the gift to the remainder beneficiaries generally will be subject to gift tax as of the time of the initial transfer of assets to the trust. Therefore, the grantor will be required to use a portion of his or her gift tax exemption equal to − or, to the extent insufficient exemption remains, to pay gift tax on − the value of the remainder interest determined as of the time the grantor funds the trust. The annuity portion of a GRAT is valued using the procedures for valuing qualified interests outlined in section 7520 (described above). To value the remainder interest in a GRAT, the value of any qualified interest, as determined under section 7520, is subtracted from the value of the property transferred to the trust.

When the grantor's retained annuity interest expires, the trust assets are distributed to one or more remainder beneficiaries identified in the trust instrument. Because the value of the transferor's gift for gift tax purposes is determined at the time of the transfer, if trust property grows at a rate in excess of the growth rate assumed under section 7520, the excess appreciation generally will pass to the remainder beneficiaries without further gift tax consequences to the grantor. If, however, the grantor dies during the trust term, that portion of the trust necessary to satisfy the annuity amount will be included in the grantor's gross estate for estate tax purposes.[249] Such inclusion generally results in the loss of the transfer tax benefit of using a GRAT.

To the extent a GRAT is structured as a grantor trust, the grantor is treated as owner of the trust and must include in determining his or her taxable income and credits those items of income, deductions, and credits of the portion of the trust deemed owned by the grantor.

Description of Proposal

The proposal imposes a requirement that a GRAT have a minimum term of 10 years.

Effective date.−The proposal is effective for trusts created after the date of enactment.

Analysis

The valuation rates and tables prescribed by section 7520 often produce relative values of annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, taxpayers often use GRATs to make gifts of property with little or no transfer tax consequences, so long as the investment return on assets in the trust is greater than the rate of return assumed under section 7520 for purposes of valuing the lead and remainder interests.

In some cases, for example, taxpayers "zero out" a GRAT by structuring the trust so that the value of the annuity interest under section 7520 equals (or nearly equals) the entire value of the property transferred to the trust. Under this strategy, the value of the remainder interest

[249] Sec. 2036.

(which is computed by subtracting the value of the annuity as determined under section 7520 from the value of the property transferred to the trust) -- and hence the value of any gift that is subject to gift taxation -- is deemed to be equal to or near zero. In reality, however, taxpayers often achieve returns on trust assets substantially in excess of the returns assumed under section 7520. Any such excess appreciation generally passes to the remainder beneficiaries without further transfer tax consequences.

Furthermore, the grantor may risk little under present law by funding a "zeroed out" GRAT with an aggressive portfolio, even where the trust assets do not perform well. If the trust yield merely equals the statutorily assumed return on trust assets, the trust principal will be returned to the grantor in the form of annuity payments. If the trust yield is less than the required annuity payments, the trustee will invade the principal of the trust, and the grantor will receive in satisfaction of his annuity interest the same property (e.g., securities or other income producing assets) used to fund the trust.[250] In either case, although the grantor has failed to achieve a low- or no-gift tax transfer to remainder beneficiaries, the grantor has lost only the use of capital during the term of the trust.

Grantors often structure GRATs with relatively short terms, such as two years, to minimize the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor's estate for estate tax purposes. Because GRATs carry little down-side risk, grantors frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the grantor's odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the grantor to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.

The budget proposal is designed to introduce additional downside risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two-year) GRATs, a GRAT with a 10-year term would carry greater risk that the grantor would die during the trust term and that the trust assets would be included in the grantor's estate for estate tax purposes.

The proposal would eliminate the use of shorter-term GRATs (i.e., GRATs with terms of less than 10 years) for gift tax avoidance. It is likely, however, that some taxpayers would continue to use GRATs with terms of 10 or more years as a gift tax avoidance tool. Even in the absence of a statutory minimum term, the use of a longer-term GRAT may be more desirable than using successive shorter term GRATs in certain circumstances, such as where the section 7520 rate is expected to increase over time. In this situation, use of a longer-term GRAT would allow the grantor to lock in the lower rate for the entire trust term. The proposal arguably would do little to curb the use of GRATs in such cases.

The proposal would not prevent the "zeroing-out" of a GRAT's remainder interest for gift tax purposes or the funding of GRATs with an aggressive portfolio. Instead, the proposal introduces downside risk only by increasing the likelihood that a grantor will die during the trust

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[250] Where the grantor is treated as owner of the trust, the distribution to the grantor generally will not be treated as a recognition event. See Rev. Rul. 85-13, 1985-1 C.B. 184.

term. Wealthy younger taxpayers may view the likelihood of dying during a 10-year trust term as remote and thus may be willing to establish one or more 10-year GRATs in an effort to avoid gift tax. The proposal might therefore have the effect of encouraging taxpayers to establish GRATs earlier in life. Long-term GRATs likely would be less attractive to taxpayers who achieve wealth only at a more advanced age.

Some might argue that a better approach would be one that achieves a more accurate valuation of the gift portion of a GRAT for gift tax purposes. This could be achieved, for example, by deferring the valuation of the remainder interest until it is distributed. Valuing the actual assets that will pass to the remainder beneficiaries at the time of the distribution, and basing the amount of the grantor's gift tax on such valuation, largely would eliminate opportunities to use a GRAT to leverage a gift tax exemption or, in the case of a "zeroed out" trust, to pass assets to heirs free of gift tax. On the other hand, some might argue that such an approach would introduce uncertainty into transfer tax planning. For example, in certain instances a grantor may not be able to predict the extent of appreciation of trust assets that will occur during the annuity term. This lack of certainty, one might argue, could result in unexpected taxable gifts by the grantor, and the grantor may have insufficient liquid assets to pay an unexpected gift tax when due.[251] Deferring valuation of the remainder interest also might create administrative challenges for the IRS; although a gift tax return is filed for the year in which assets are transferred to the trust, the value for gift tax purposes would not be determined until the interest is distributed, which could occur many years later.

Prior Action

No prior action.

[251] Such uncertainty could be addressed, however, though an election under which a grantor agrees to have trust assets invested only in certain less aggressive instruments likely to produce an average return not greater than the return assumed under section 7520. This would limit a grantor's ability to manipulate the GRAT valuation assumptions to pass assets to heirs free of gift tax.