General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals

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GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS

Introduction

This report summarizes the revenue proposals in the Administration's Fiscal Year 2004 Budget. These proposals include the economic growth package of proposals, which is designed to reinvigorate the economic recovery, create jobs, and enhance long-term economic growth. The other proposals, also intended to strengthen the American economy, affect a wide range of areas including encouraging saving, strengthening education, investing in health care, increasing housing opportunities, protecting the environment, encouraging telecommuting, and providing incentives for charitable giving, as well as simplifying the tax laws and improving tax administration. To maintain their favorable effects and provide greater certainty for economic and financial planning, the proposals extend several tax provisions that expire in 2003 and 2004 and permanently extend the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 as well as the Research and Experimentation tax credit.

As announced in last year's Budget, the Administration is pursuing a tax simplification project which is focusing on immediately achievable reforms of the current tax system. Several proposals in this year's Budget result from this project. They include the proposals relating to: creating a uniform definition of a qualifying child, eliminating the phase-out of adoption tax benefits, repealing the restrictions on the use of qualified 501(c)(3) bonds in refinancing taxable debt and working capital debt and in providing residential rental housing, simplifying use of the orphan drug tax credit for pre-designation costs, exclusion from income of the value of employer-provided computers, consolidating IRAs into Lifetime Savings Accounts and Retirement Savings Accounts (LSAs/RSAs), consolidating defined contribution retirement plans into Employer Retirement Savings Accounts (ERSAs), allowing section 179 expensing elections to be made or revoked on amended returns, and conforming and simplifying the Work Opportunity Tax Credit and the Welfare to Work Tax Credit. Additional tax simplification proposals are under development by the Treasury's Office of Tax Policy and will be released during the coming year.

ADMINISTRATION PROPOSALS

ECONOMIC GROWTH PACKAGE

Rationale[1]

In 2001, the Administration worked with Congress to reduce income taxes for everyone who pays them – more than 100 million individuals, families, and sole proprietors received tax relief. Tax relief began immediately in July 2001 through reductions in tax rates and through advancing the benefits of a new, lower rate, 10-percent tax bracket by sending checks of up to $600 per taxpayer. Additional tax relief was received when taxpayers filed their 2001 tax returns in 2002, and further rate reductions took effect in 2002. However, the 2001 Act also delayed significant tax relief until 2004, 2006, and later years.

The economy has shown great resilience over the past two years in the face of sharp declines in the stock market since March 2000, the terrorist attacks of September 11, 2001, and an ongoing war against terrorism. The U.S. economy continues to recover and long-run fundamentals are solid, with low inflation and strong productivity growth. Despite the strong underlying fundamentals, the recovery is slow. Businesses are expanding production only slowly and too few jobs are being created. Many employers lack the confidence to invest and hire additional workers.

The President's proposed Economic Growth Package responds to the slow current economic recovery and builds a foundation for strong economic growth in the future. The greatest strengths of this economy now and in the future are the productivity and entrepreneurial spirit of Americans. High tax rates discourage individuals from investing in themselves through training and education since their higher earnings bear higher taxes. High tax rates discourage entrepreneurship, because the successful small business owner keeps less of any additional amount that is earned. High tax rates slow the economy, and a slowly growing economy produces fewer jobs for individuals wanting to work.

The Economic Growth Package provides immediate acceleration of significant tax relief enacted in 2001 that is scheduled, under current law, to phase-in on a delayed basis. The proposal moves to this year the expansion of the 10-percent tax bracket, scheduled under current law for 2008, as well as marginal tax rate reductions, scheduled under current law to take place in 2004 and 2006. It further reduces taxes by putting marriage penalty relief provisions, scheduled under current law to take place between 2005 and 2009, in place for 2003. The Growth Package also provides for the immediate acceleration of the Child Tax Credit, scheduled under current law to take place between 2005 and 2010. The proposal also provides for temporary alternative minimum tax (AMT) relief to ensure that additional taxpayers do not become subject to the complicated rules of the AMT merely because of the legislated tax relief provided.

[1] This section provides the rationale for the Economic Growth Package as a whole. Additional specific reasons for change are provided with the descriptions of the proposals to eliminate the double taxation of corporate earnings and to increase expensing for small business.

Increases in the level of investment are essential to ensuring future increases in productivity, the key to an increasing standard of living for Americans. Higher levels of investment bring higher wages as each worker can produce more with better and more efficient plant, equipment, and technology. The Economic Growth Package provides a significant reduction in the cost of undertaking new investment by eliminating the double tax on corporate earnings. Under current law, income earned by a corporation is first taxed at the corporate level and then taxed a second time when distributed to shareholders as dividends. Corporate earnings that are retained are also subject to a second tax when shareholders sell their stock and the appreciation representing these retained earnings is taxed again. Double taxation can result in rates of tax as high as 60 percent, far in excess of rates of tax imposed on other income.

Under the proposal, corporate income would be subject to only one level of tax. Dividends paid out of income that was fully taxed at the corporate level would be excluded from tax at the shareholder level. Similarly, if a company retained earnings out of income that was fully taxed at the corporate level, shareholders would be permitted to increase their basis in their shares to reflect the previously taxed retained earnings of the firm. The basis increase would eliminate any capital gains tax liability arising directly from retentions of previously taxed earnings.

Elimination of the double tax on corporate earnings can result in significant efficiency gains for the economy and reduce the cost to corporations of undertaking new investment. Elimination of the double tax reduces other tax-induced distortions in the economy. Because, under current law, interest payments on debt are deductible but payments of dividends on equity are not, corporations rely too much on debt to finance their investment. An excessive use of debt finance can make corporations more vulnerable during economic downturns to financial distress and may lead to bankruptcy. The bias in the current system against paying dividends can result in a reduced pressure on corporate managers to make the most efficient use of retained earnings, because corporate investments funded by retained earnings may receive less scrutiny than investments funded by new, outside sources of capital.

The proposal provides further support for investment by significantly expanding the amount of investment that may be immediately deducted by a small business. The increased cash flow and reduced effective costs for making new investments allows small businesses to expand and create new employment opportunities.

The components of the President's Economic Growth Package work together to enhance growth in the near-term and in the long-term. The components of the Economic Growth Package are described in more detail in this section.

ACCELERATE 10-PERCENT INDIVIDUAL INCOME TAX RATE BRACKET EXPANSION

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 split the prior law 15-percent individual income tax rate bracket into two tax rate brackets of 10 and 15 percent. The 10-percent tax rate bracket applies to the first $6,000 of taxable income for single taxpayers and married taxpayers filing separate returns (increasing to $7,000 for taxable years 2008 and later), the first $10,000 of taxable income for heads of household, and the first $12,000 of taxable income for married taxpayers filing joint returns (increasing to $14,000 for taxable years 2008 and later). The income thresholds for the new tax rate brackets will be adjusted annually for inflation, effective for taxable years beginning after 2008. Taxable income above these thresholds that was taxed at the 15-percent rate under prior law will continue to be taxed at the 15-percent tax rate.

Under current law, the 10-percent tax rate bracket would be eliminated when tax rates return to their pre-EGTRRA levels after taxable year 2010.

Proposal

The Administration proposes to accelerate to 2003 the expansion of the 10-percent bracket scheduled for 2008. Effective for taxable years beginning after December 31, 2002, the 10-percent tax rate bracket would apply to the first $7,000 of taxable income for single taxpayers and married taxpayers filing separate returns, the first $10,000 of taxable income for heads of household, and the first $14,000 of taxable income for married taxpayers filing joint returns. The income thresholds for the 10-percent tax rate brackets would be adjusted annually for inflation, effective for taxable years beginning after December 31, 2002. The 10-percent tax rate bracket would remain in effect for taxable years beginning after 2010 as a result of the Administration's separate proposal to permanently extend the EGTRRA provisions.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-978	-7,782	-6,112	-6,117	-6,495	-4,275	-30,781	-47,194

ACCELERATE REDUCTION IN INDIVIDUAL INCOME TAX RATES

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 lowered the tax rates in the four tax rate brackets higher than 15 percent from 28, 31, 36, and 39.6 percent to 25, 28, 33, and 35 percent. The reduced tax rates are phased in over a period of six years in four steps, beginning with taxable year 2001, according to the following schedule:

Taxable Year	28% rate is reduced to:	31% rate is reduced to:	36% rate is reduced to:	39.6% rate is reduced to:
2001	27.5%	30.5%	35.5%	39.1%
2002 – 2003	27%	30%	35%	38.6%
2004 – 2005	26%	29%	34%	37.6%
2006 – 2010	25%	28%	33%	35%

The width of each of these tax brackets is adjusted annually to reflect inflation during the preceding year.

Under current law, these rates return to their pre-EGTRRA levels after taxable year 2010.

Proposal

The income tax rate reduction scheduled for 2004 and 2006 would be accelerated to 2003. Effective for taxable years beginning after December 31, 2002, the 27-percent rate would be reduced to 25 percent; the 30-percent rate would be reduced to 28 percent; the 35-percent rate would be reduced to 33 percent; and the 38.6-percent rate would be reduced to 35 percent. The lower rates would remain in effect for taxable years beginning after December 31, 2010 as a result of the Administration's separate proposal to permanently extend all provisions of EGTRRA.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-5,808	-35,693	-17,470	-4,939	0	0	-58,102	-58,102

ACCELERATE 15-PERCENT INDIVIDUAL INCOME TAX RATE BRACKET EXPANSION FOR MARRIED TAXPAYERS FILING JOINT RETURNS

Current Law

A married couple has a marriage penalty if they owe more income tax filing a joint return than the couple would pay if they were unmarried and each filed a separate return. Marriage penalties often arise because the size of the rate brackets for joint filers is less than twice the size for single filers or head of household filers. In 2003, the maximum taxable income in the 15-percent tax rate bracket is 167 percent of the corresponding amount for an unmarried individual filing a single return.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increases the size of the 15-percent tax rate bracket for married taxpayers filing joint returns over a four-year period, beginning after December 31, 2004. The increase is as follows: the maximum taxable income in the 15-percent tax rate bracket for married taxpayers filing joint returns increases to 180 percent of the corresponding amount for single taxpayers in taxable year 2005, 187 percent in taxable year 2006, 193 percent in taxable year 2007, and 200 percent in taxable years 2008, 2009, and 2010.

Proposal

The maximum taxable amount in the 15-percent tax rate bracket for married taxpayers filing joint returns would be increased to 200 percent of the corresponding amount for single taxpayers, effective for taxable years beginning after December 31, 2002. The Administration is also proposing to permanently extend the EGTRRA provisions in 2010. Thus, the expanded 15-percent tax rate bracket for married taxpayers would also apply to taxable years beginning after December 31, 2010.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-2,042	-19,889	-10,171	-4,718	-1,785	-463	-37,026	37,026

ACCELERATE INCREASE IN STANDARD DEDUCTION FOR MARRIED TAXPAYERS FILING JOINT RETURNS

Current Law

A couple has a marriage penalty if they owe more income tax filing a joint return than the couple would pay if they were unmarried and each filed a separate return. Marriage penalties often arise because the standard deduction for joint filers is less than twice the corresponding amounts for single filers or head of household filers. In 2003, the basic standard deduction amount for a married couple filing a joint return is 167 percent of the corresponding amount for an unmarried individual filing a single return.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increases the standard deduction for married couples filing joint returns to double the standard deduction for single taxpayers over a five-year period, beginning after December 31, 2004. The standard deduction for married taxpayers filing joint returns increases to 174 percent of the standard deduction for single taxpayers in taxable year 2005, 184 percent in taxable year 2006, 187 percent in taxable year 2007, 190 percent in taxable year 2008, and 200 percent in taxable years 2009 and 2010.

Proposal

The standard deduction for married taxpayers filing joint returns would be increased to 200 percent of the standard deduction for single taxpayers, effective for taxable years beginning after December 31, 2002. The Administration is also proposing to permanently extend the EGTRRA provisions expiring in 2010. Thus, the increase in the standard deduction for married taxpayers would also apply to taxable years beginning after December 31, 2010.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-735	-7,245	-4,509	-2,924	-1,811	-1,272	-17,761	18,185

ACCELERATE INCREASE IN CHILD TAX CREDIT

Current Law

Taxpayers may be eligible for a tax credit of up to $600 for each qualifying child under the age of 17. The credit increases to $700 for taxable years 2005 through 2008, $800 for taxable year 2009, and $1,000 for taxable year 2010. The credit declines to $500 in taxable year 2011. The credit is reduced by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds $110,000 ($75,000 if the taxpayer is not married and $55,000 if the taxpayer is married but filing a separate return). The credit amounts and income thresholds are not adjusted for inflation. For taxable years before January 1, 2011, the credit offsets both the regular and the alternative minimum tax.

The child tax credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,500. The percentage increases to 15 percent for taxable years 2005 through 2010. The $10,500 earned income threshold is indexed annually for inflation. Families with three or more children are allowed a refundable credit for the amount by which their social security payroll taxes exceed the refundable portion of their earned income tax credit, if that amount is greater than the refundable credit based on their earned income in excess of $10,500. For taxable years beginning after December 31, 2010, the credit is nonrefundable unless the taxpayer has three or more children and social security taxes in excess of the refundable portion of the earned income tax credit.

Proposal

The amount of the child tax credit would be increased by $400 to $1,000 per child. The proposal would be effective for taxable years beginning after December 31, 2002.

In 2003, the increased amount of the child tax credit (up to $400) would be paid in advance beginning in July 2003 on the basis of information on the taxpayer's 2002 tax return filed in 2003. Advance payments would be made in a manner similar to the distribution of advance payment checks in 2001.

The Administration is also proposing to permanently extend the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provisions expiring in 2010. Thus in taxable years beginning after December 31, 2010, the credit would be $1,000, would offset the alternative minimum tax, and would be partially refundable for families with one or two children.

Revenue Estimate[2]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-13,827	-6,134	-15,518	-12,806	-12,727	-12,644	-59,829	-78,545

[2] The estimate includes both receipt and outlay effects. The outlay effect for the proposal is $300 million in fiscal year 2003, $1,074 million in fiscal year 2004, $4,783 million in fiscal year 2005, $4,272 million in fiscal year 2006, $4,195 million in fiscal year 2007, $4,142 million in fiscal year 2008, $4,102 million in fiscal year 2009 and $2,671 in fiscal year 2010. The outlay effect is $18,466 million in fiscal years 2004 through 2008 and $25,239 million in fiscal years 2004 through 2013.

ELIMINATE THE DOUBLE TAXATION OF CORPORATE EARNINGS

Current Law

Income earned by a corporation is taxed at the corporate level, generally at the rate of 35 percent. If the corporation distributes earnings to shareholders in the form of dividends, the income generally is taxed a second time at the shareholder level (at rates as high as 38.6 percent). If a corporation instead retains its earnings, the value of corporate stock will reflect the retained earnings. When shareholders sell their stock, that additional value will be taxed as capital gains (generally at a maximum rate of 20 percent for long-term capital gains). The combined rate of tax on corporate income can be as high as 60 percent, far in excess of rates of tax imposed on other types of income.

Reasons for Change

The double taxation of corporate profits creates significant economic distortions.

- First, double taxation creates a bias in favor of debt as compared to equity, because payments of interest by the corporation are deductible while returns on equity in the form of dividends and retained earnings are not. Excessive debt increases the risks of bankruptcy during economic downturns.

- Second, double taxation of corporate profits creates a bias in favor of unincorporated entities (such as partnerships and limited liability companies), which are not subject to the double tax.

- Third, because dividends are taxed at a higher rate than are capital gains, double taxation of corporate profits encourages a corporation to retain its earnings rather than distribute them in the form of dividends. This lessens the pressure on corporate managers to undertake only the most productive investments because corporate investments funded by retained earnings may receive less scrutiny than investments funded by outside equity or debt financing.

- Fourth, double taxation encourages corporations to engage in transactions such as share repurchases rather than to pay dividends because share repurchases permit the corporation to distribute earnings at reduced capital gains tax rates.

- Fifth, double taxation increases incentives for corporations to engage in transactions for the sole purpose of minimizing their tax liability.

By eliminating double taxation, the proposal will reduce tax-induced distortions that, in the current tax system, encourage firms to use debt rather than equity finance and to adopt noncorporate rather than corporate structures. Because shareholders will be exempt from tax only on distributions of previously taxed corporate income, the proposal will reduce incentives for certain types of corporate tax planning. In addition, the proposal will enhance corporate governance by eliminating the current bias against the payment of dividends. Dividends can provide evidence of a corporation's underlying financial health and enable investors to evaluate more readily a corporation's financial condition. This, in turn, increases the accountability of corporate management to its investors.

Proposal

Overview

The proposal would integrate the corporate and individual income taxes so that corporate earnings generally will be taxed once and only once. Under the proposal, public and private corporations would be permitted to distribute nontaxable dividends to their shareholders to the extent that those dividends are paid out of income previously taxed at the corporate level. The proposal generally would be effective for distributions made on or after January 1, 2003, with respect to corporate earnings after 2000.

To calculate the amount that can be distributed to its shareholders without further tax, a corporation will compute an excludable dividend amount (EDA) for each year. The EDA reflects income of the corporation that has been fully taxed. Thus, for example, a corporation with $100 of income that pays $35 of U.S. income taxes will have an EDA of $65 that can be distributed as excludable dividends.

If an amount would be a dividend under current law, it will be treated as an excludable dividend to the extent of EDA. Excludable dividends will not be taxed to shareholders. If a corporation's distributions during a calendar year exceed its EDA, only a proportionate amount of each distribution will be treated as an excludable dividend. Ordering rules are provided below for distributions that exceed EDA.

The capital gains tax on the sale of stock will be retained. Without further change, this would create an incentive for corporations to distribute previously taxed income as excludable dividends rather than retaining earnings for future investment. This is because excludable dividends would not be taxed to the shareholders but capital gains that represent retained earnings would be taxed to the shareholders when they sell their shares.

To ensure that distributions and retentions of previously taxed earnings are treated similarly, shareholders will be permitted to increase their basis in their shares to reflect that the retained earnings have already been taxed at the corporate level. As an alternative to distributing excludable dividends, corporations generally may allocate throughout the year all or a portion of the EDA to provide these basis increases. The basis increases will not be taxable. The effect of the basis increases will be to reduce the capital gains realized when shareholders sell their stock to the extent that the sales price reflects the corporation's retained, previously taxed earnings.

Technical Explanation

Corporate Level

A. In General

Corporations will continue to calculate their income under current law rules and will pay tax according to the existing graduated rate schedule. The corporate alternative minimum tax (AMT) will continue to apply.

The rules for computing earnings and profits will be retained. The rules for treating corporate level transactions, such as acquisitive and divisive reorganizations, liquidations, and taxable acquisitions will generally be the same as under current law. Corporations may continue to file consolidated returns as under current law. The consolidated return regulations will be amended to reflect the dividend exclusion.

B. The Excludable Dividend Amount

Corporations will be able to determine with certainty on January 1 the amount of their EDA for the year.

To compute EDA, the corporation will first convert U.S. income taxes shown on its U.S. income tax return filed during the prior year into an equivalent amount of income taxed at a 35 percent rate. The formula divides U.S. income taxes shown on the return by the maximum statutory corporate tax rate (currently 35 percent) and then subtracts the U.S. income taxes shown on the return. For purposes of the computation, U.S. income taxes includes U.S. income taxes on foreign source income that have been offset by foreign tax credits. It also includes AMT.

Although the graduated rates of tax on corporate income set forth in section 11(b) will still apply, taxes will be grossed-up for purposes of calculating the EDA as if all income were subject to U.S. tax at a 35 percent rate. Similarly, taxes paid at the AMT rate will be grossed-up at a 35 percent rate. Because the proposal treats AMT as U.S. income taxes, it will not treat as U.S. income taxes the portion of regular taxes that are offset by the AMT credit allowed under section 53.

These steps in calculating EDA are illustrated as follows:

$$\frac{\text{U.S. income taxes}}{.35} - \text{U.S. income taxes}$$

The calculation of EDA then adds excludable dividends received in the prior year by the corporation as a shareholder and retained earnings basis adjustments (as described below) for the prior year made with respect to stock owned by the corporation. For example, an excludable dividend received by a corporation on March 31, 2004, will be included in its EDA for 2005. These additions to EDA will ensure that multiple levels of corporate ownership do not result in more than one level of tax on income that has been previously taxed at the corporate level.

For purposes of computing a corporation's EDA for a particular calendar year, U.S. income taxes means U.S. income taxes (other than estimated taxes) shown on returns filed by the corporation in the previous calendar year. Thus, for example, U.S. income taxes shown on a return filed on September 15, 2005, will be used to compute EDA for 2006. In addition, U.S. income taxes include U.S. income taxes paid pursuant to an assessment of deficiency in that year and will be reduced, but not below zero, by refunds of income taxes paid during that year. Refunds of income taxes and payments of additional income taxes that are attributable to a taxable year the return for which was filed prior to January 1, 2002, will not be included in the computation of the EDA.

To the extent the EDA for a particular calendar year exceeds the current and accumulated earnings and profits, the excess will be added to the EDA for the following calendar year. Otherwise, any remaining EDA not distributed or added to shareholder basis will expire.

C. Retained Earnings Basis Adjustments

As an alternative to distributing excludable dividends, corporations will be permitted to allocate throughout the year all or a portion of their EDA to increase their shareholders' basis in their stock.

The sum of excludable dividends and basis increases cannot exceed the lesser of EDA or current and accumulated earnings and profits. As described below, all dividend distributions during the year will be treated as excludable dividends to the extent of EDA. Consequently, basis increases will be permitted only to the extent that the total dividend distributions during the year do not exceed EDA. If the corporation's earnings and profits is less than EDA, then basis increases are limited to the excess of earnings and profits over excludable dividends.

The basis increases will not be taxable. Basis increases will reduce the EDA and earnings and profits.

Basis increases must be allocated in the same manner as a distribution would be allocated. Basis increases may not be allocated, however, to stock that is preferred and limited as to dividends. Regulations may address other situations where a corporation has multiple classes of stock.

Allocated basis increases reflecting retained earnings are referred to as REBAs. A corporation will maintain records of the total REBAs made with respect to its stock in prior years. The cumulative amount of REBAs for all years is referred to as the CREBA.

From time to time, a corporation's EDA for a calendar year may be less than the distributions it intends to make. Instead of treating distributions in excess of EDA as taxable dividends, as described below, the proposal treats those distributions as effectively reversing basis adjustments that were allocated in prior years. These distributions reduce CREBA. This flexibility reflects the fact that, even though a corporation's taxable income may fluctuate, it may maintain a stable dividend payout.

D. Distributions

For a distribution to be an excludable dividend, it must be a dividend under current law, i.e., out of earnings and profits.

If a distribution is a dividend under current law, it will be treated as an excludable dividend to the extent of EDA. Distributions that are excludable dividends reduce EDA and earnings and profits.

If dividend distributions are less than EDA, a corporation may permit its shareholders to increase their basis in their stock as discussed above.

If a corporation's distributions during a calendar year exceed its EDA, only a proportionate amount will be treated as an excludable dividend.

Distributions that are not excludable dividends generally will be treated as:

- first a return of basis and then capital gain to the extent of the CREBA,
- then a taxable dividend to the extent of the corporation's earnings and profits,
- then a return of capital to the extent of the shareholder's remaining basis, and
- then capital gain.

The distinction between a redemption distribution that is treated as a dividend and a redemption that is treated as a sale or exchange of stock will remain as under current law. The proposal, however, may modify the attribution rules (particularly as they relate to options) for purposes of determining whether a redemption distribution is treated as a dividend.

A redemption that is treated as a sale or exchange of stock will reduce pro rata the redeeming corporation's current year EDA and CREBA. For example, if a corporation redeems two percent of its stock, the corporation will reduce its current year EDA and CREBA by two percent.

The rules under sections 304, 305, and 306 will be retained. To the extent that those rules characterize transactions as distributions to which sections 301 and 316 apply, EDA will be reduced accordingly.

E. Refunds of Taxes

The rules governing refunds of taxes will be revised to ensure that EDA for a year in which shareholders have already derived a benefit is not affected. In general, if a refund is due in a particular calendar year, the refund will be paid to the extent the corporation has paid U.S. income taxes shown on a final return previously filed in that calendar year. If any refund remains unpaid, the corporation may recompute its EDA for the current year as if the refund reduced the U.S. incomes taxes previously used to compute the current year's EDA. This permits an additional refund to be paid currently. The recomputed EDA will be used to determine the character of distributions made, and the amount of basis adjustments permitted to be allocated, during the entire year. Any refund that is not paid currently will be credited against future tax liability.

Refunds attributable to a taxable year the return for which was filed prior to January 1, 2002, will be paid as under current law.

F. Carryback of Net Operating Losses

The rules governing the carryback of net operating losses will be revised to ensure that EDA for a year in which shareholders have already derived a benefit is not affected. Accordingly, under the proposal, net operating losses of corporations may be carried back one year. For example, a net operating loss attributable to a taxable year ending during 2003 may be carried back one year to the taxable year ending in 2002. If a net operating loss is carried back, however, the EDA for the current year must be recomputed. That recomputed EDA will be used to determine the character of distributions made, and the amount of basis adjustments allocated, during the entire year.

The proposal will not affect the carryback period for net operating losses that are carried back to a taxable year the return for which was filed prior to January 1, 2003.

G. Reorganizations and Liquidations

The proposal retains current law rules that treat a qualifying corporate reorganization and certain corporate liquidations as tax-free at the shareholder level and at the corporate level. Under current law, the acquired corporation's tax attributes, including its asset basis, carry over to the acquiror. These rules will be amended to provide for the carryover of the acquired corporation's EDA and CREBA.

The proposal retains current law rules governing tax-free spin-offs. Under the proposal, rules will be provided to divide the CREBA, if any, of the distributing and controlled corporations between the distributing and controlled corporations based on the relative fair market values of their assets and to ensure that duplicate CREBA is eliminated.

H. Consolidated Returns

The Secretary of the Treasury will amend the consolidated return regulations to effect the provisions of the proposal. For example, regulations might provide that, in a consolidated group, EDA will be calculated on a consolidated group basis based on U.S. income taxes of the group, and then apportioned among the entities that were members of the group during the taxable year based on each member's separate taxable income. No EDA will be allocated to members that generated a loss during the taxable year. The stock basis adjustment rules of the current consolidated return regulations, rather than the rules described above, will control for members of a consolidated group.

I. Limits on Tax Motivated Acquisitions

Section 269 will apply, as under current law, to discourage tax motivated acquisitions, including acquisitions undertaken for the purpose of obtaining an EDA or a CREBA. Because EDA generally expires at the end of each year, the proposal does not include section 382-type rules.

J. Accumulated Earnings Tax and Personal Holding Company Tax

The accumulated earnings tax and personal holding company tax will be repealed because they are of diminished importance in a system that does not impose a shareholder level of tax on dividends. Their repeal will simplify compliance with the tax laws.

K. Foreign Corporations

U.S. income taxes on income of a foreign corporation that is effectively connected with a U.S. trade or business will be treated as U.S. income taxes for purposes of the EDA computation. Branch profits taxes will not be treated as U.S. income taxes for purposes of computing EDA, and any branch profits taxes paid will reduce a foreign corporation's EDA. A foreign corporation's EDA will be increased by any excludable dividends received by it as a shareholder as well as distributions from CREBA of the distributing corporation, reduced by any applicable U.S. withholding taxes. U.S. withholding taxes imposed on a foreign corporation will not be treated as U.S. income taxes for purposes of the EDA computation.

Consistent with the general rule, distributions from a foreign corporation first will be attributable to EDA and then CREBA. Shareholders receiving distributions of those amounts will not be entitled to receive foreign tax credits for foreign taxes paid or accrued with respect to those amounts.

L. S Corporations

The S corporation rules will be retained under the proposal with certain modifications. Under current law, the income of S corporations is subject to an entity level tax only in limited circumstances. To the extent an S corporation pays income tax at the corporate level, the S corporation will compute EDA based on that tax and the income subject to that tax will not be taxed again at the shareholder level.

In addition, under the proposal, distributions first will be treated as excludable dividends to the extent that the corporation's EDA does not exceed its earnings and profits and then will be from CREBA. After these distributions, the remainder will be characterized as under current law.

M. Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)

Under the proposal, a RIC or a REIT that has excludable dividend income will generally pass through this income as excludable to its shareholders. In addition, RICs and REITS will be able to pass through REBAs as basis adjustments.

Under current law, RICs and REITs are entitled to a deduction for the dividends they distribute to their shareholders. Under the proposal, RICs and REITs will not be allowed a deduction for distributions that are designated as excludable or from CREBA. For purposes of the distribution requirements of RICs and REITs, excludable dividends will be treated in the same manner as tax-exempt interest.

N. Insurance Companies

Insurance companies are allowed to deduct benefits paid on insurance contracts (death benefits, annuity payments, payments for property and casualty losses) plus an estimate of benefits to be paid in the future (i.e., amounts added annually to reserves held by the company to fund future benefit payments). Under current law, to prevent a double benefit with respect to exempt income, insurance companies are required to allocate exempt earnings on a pro rata basis between the insurance company's general earnings and those amounts set aside to pay benefits. Any earnings otherwise exempt that are allocated to pay benefits are treated as not exempt from tax. These allocations are made by means of certain proration rules. These rules set forth computations that produce the percentage of exempt income to be allocated to the company and the percentage to be treated as held to pay policy benefits.

Under the proposal, all excludable dividends will be subject to proration. The basis increase attributable to REBAs will be adjusted to take into account these proration rules. In addition, all excludable dividends and REBAs attributable to assets held in a separate account funding variable life insurance and annuity contracts will be allocated to the separate account.

O. Cooperatives

Cooperatives will compute EDA in the same manner as a C corporation and will be permitted to distribute excludable dividends or to allocate REBAs to the extent of EDA.

Shareholder Level

A. Distributions

1. In General

Under the proposal, shareholders generally will exclude from gross income dividends that are characterized as excludable dividends. Each year, shareholders will receive a Form 1099 from the corporation setting forth which portions of their distributions are excludable dividends, taxable dividends, or returns of capital. In addition, the statement will show the amount by which shareholders are entitled to increase their basis in their stock as a result of REBAs.

2. Special Rules for Dividend Exclusion and REBAs

Under current section 246(c), corporate shareholders must hold their stock for more than 45 days (and for more than 90 days in the case of preferred stock) during the 90-day period (and the 180-day period in the case of preferred stock) beginning 45 days (and 90 days in the case of preferred stock) before the ex-dividend date to be eligible to claim a dividends received deduction. A rule similar to section 246(c), with the same holding period requirements, will apply to excludable dividends received and REBAs allocated to both corporate and noncorporate shareholders.

Under current law, section 1059 requires stock basis reductions for certain dividends received by corporate shareholders. Under the proposal, section 1059 will be extended to apply to excludable dividends received and REBAs allocated to both corporate and noncorporate shareholders. For purposes of the section 246(c) and 1059 rules, a shareholder who acquires stock from a decedent will treat its holding period with respect to that stock as beginning on the date used for purposes of determining the fair market value of the stock for estate tax purposes.

Under current section 852(b)(4), if a shareholder of a RIC receives an exempt-interest dividend in respect of a share held by the shareholder for 6 months or less, any loss on the sale of the share is disallowed to the extent of the exempt-interest dividend. Similar rules will be provided if a shareholder of a RIC receives a distribution that is designated as an excludable dividend or is entitled to make a REBA.

B. Capital Gains

Shareholders will be taxed on sales of their stock, as under current law. REBAs should largely prevent shareholders from being taxed on the portion of appreciation in the value of their shares that is attributable to previously taxed income that the corporation has chosen to retain rather than pay out as dividends. The capital loss limitation will remain as under current law.

C. Redemptions

In general, a redemption of stock is characterized as either a distribution under section 301 or a sale or exchange of stock as under current law.

D. Corporate Shareholders

Under the proposal, an excludable dividend received by a U.S. corporation will not be taxable. Excludable dividends received by a corporation will increase the recipient corporation's EDA and will, therefore, remain excludable when distributed by the recipient corporation.

Under current law, a corporation that receives a dividend from another corporation is entitled to a dividends received deduction. Under the proposal, the 100 percent deduction for dividends received from a corporation 80 percent or more of which is owned by another corporation will be retained. The 70 and 80 percent deductions for dividends received, however, will only be available for distributions of pre-2001 earnings and profits that are distributed before January 1, 2006, with respect to stock issued before February 3, 2003.

E. Shareholder Level Debt

Section 246A, which prohibits the dividends received deduction for debt-financed portfolio stock, will be modified to require that otherwise excludable dividends received by corporations be included in income if attributable to debt-financed stock. Additionally, because under section 163(d) excludable dividends will not be treated as investment income, excludable dividends will not increase the amount deductible as investment interest.

F. Shareholder AMT

The proposal does not affect the alternative minimum tax. Excludable dividends will not be an AMT adjustment or preference. In addition, excludable dividends will not be a preference for adjusted current earnings for corporate AMT.

G. Foreign Shareholders

In the case of foreign shareholders, the withholding tax on dividends will be retained for distributions out of earnings and profits, whether or not excludable, and will apply to distributions from CREBA. U.S. withholding tax will not apply to REBAs.

REBAs allocable to stock held by a foreign shareholder will not increase the basis of the foreign shareholder's stock. Any distributions to a foreign shareholder from CREBA will not decrease the foreign shareholder's stock basis.

If the foreign shareholder is a corporation, distributions of excludable dividends, reduced by any applicable U.S. withholding taxes, will increase the EDA of the foreign shareholder. REBAs will not increase the EDA of a foreign corporate shareholder. Distributions from the distributing corporation's CREBA to foreign corporate shareholders will be treated in the same manner as an excludable dividend received.

H. Pension Plans, 401(k) Plans, and Individual Retirement Accounts (Retirement Plans)

In a Retirement Plan, all investment income, including all dividend income, is effectively free from tax. The proposal's treatment of Retirement Plans will not change current law.

Generally, under current law, amounts contributed to a Retirement Plan are not subject to tax when contributed. Income of the Retirement Plan is not subject to tax when earned. Instead, contributions and earnings are subject to tax when distributed. In contrast, contributions to a Roth-IRA are made with after-tax dollars. However, both the after-tax contributions and income earned on those contributions are free from tax when distributed.

All investment income, including dividend income, earned by a Roth-IRA is free from tax. The tax treatment of other retirement plans is economically equivalent to Roth-IRA treatment. A plan with tax-free contributions and no tax until withdrawal produces the same after-tax benefit for an individual as a plan with after-tax contributions and tax-free investment returns.

Because all investment income is effectively free from tax in Retirement Plans, investments in these plans will remain tax advantaged relative to investments outside of these plans.

I. Employee Stock Ownership Plans (ESOPs)

Under current law, a corporation is entitled to a deduction for certain dividends paid with respect to shares held by an ESOP sponsored by the corporation or another corporation in the same controlled group. Under the proposal, an otherwise excludable dividend will be taxable if a deduction is allowed in respect of such dividend. The amount of the dividend, however, will not reduce a distributing corporation's EDA. If both a deduction and an exclusion for a dividend were permitted, then the amounts paid would not be taxed at either the corporate or the shareholder level.

In addition, REBAs will not be permitted to be made to the basis of shares held by an ESOP. The corporation will be permitted a deduction for distributions from CREBA in respect of shares held by an ESOP. Correspondingly, such distributions will not decrease the basis of such shares and, instead, will be taxable if paid in cash. Finally, such amounts will not reduce a distributing corporation's CREBA.

J. Private Foundations

Under current law, private foundations are subject to tax on net investment income. Under the proposal, excludable dividends and distributions from CREBA will not be included in the calculation of net investment income for this purpose.

K. Treatment of Owner of Rights to Acquire Stock

Under the proposal, the Secretary may promulgate regulations treating the holder of a right to acquire stock as a shareholder as necessary to prevent the creation of stock losses or reduction of stock gains.

Reporting and Recordkeeping

Forms 1099 will be revised to provide information to shareholders to indicate the amounts of excludable dividends, taxable dividends, and returns of capital. The revised form will also indicate the amounts of REBAs so that shareholders can adjust their basis.

A corporation will calculate the EDA and the CREBA and will report those amounts to the IRS annually on its income tax return.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
-2,665	-24,224	-25,962	-31,501	-33,996	-36,983	-152,666	-385,429

INCREASE EXPENSING FOR SMALL BUSINESS

Current Law

Section 179 provides that, in place of depreciation, certain taxpayers may elect to deduct up to $25,000 of the cost of qualifying property placed in service each year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software generally does not qualify for the Section 179 deduction because it is intangible property. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $200,000. More generous incentives are provided for investment in the New York Liberty Zone or in an empowerment zone or renewal community. An election for the Section 179 deduction must generally be made on the taxpayer's initial tax return to which the election applies. The election can be revoked only with the consent of the Commissioner.

Reasons for Change

Expensing encourages investment by lowering the after-tax cost of capital purchases, relative to claiming regular depreciation deductions. Expensing is also simpler than claiming regular depreciation deductions, which is particularly helpful for small businesses. Raising the amount of total investment at which the phase-out begins would increase the number of taxpayers eligible for Section 179 expensing.

The exclusion of off-the-shelf computer software from Section 179 is confusing to many taxpayers and puts purchased software at a disadvantage relative to developed software (for which development costs can generally be expensed as incurred).

Small business taxpayers may not always be aware of the advantages or disadvantages of Section 179 expensing.[3] For example, a taxpayer may want to make an election on an amended return if the taxpayer was not aware of the Section 179 election or if changes on an amended return make the taxpayer eligible for the election. Alternatively, a taxpayer may want to revoke a previous Section 179 election if the taxpayer determines that it was not to the taxpayer's advantage. However, a taxpayer is precluded from revoking a Section 179 election on an amended return without incurring the expense and uncertainty of requesting the consent of the Commissioner.

Proposal

The proposal would increase the maximum amount of qualified property that a taxpayer may deduct under Section 179 to $75,000. The proposal would raise the amount of total qualifying investment at which the phase-out begins to $325,000 per year and include off-the-shelf computer software as qualifying property. Both the deduction limit and phase-out threshold would be indexed annually for inflation. Additionally, the Administration proposes to allow expensing elections to be made or revoked on amended returns.

The proposal would be effective for taxable years beginning on or after January 1, 2003.

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[3] A Section 179 election may not be to a taxpayer's advantage if, for example, it limits his or her income and makes various tax credits unusable.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
($'s in millions)							
-1,023	-1652	-1,776	-1,912	-1,601	-1,431	-8,372	-14,583

PROVIDE MINIMUM TAX RELIEF TO INDIVIDUALS

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the alternative minimum tax (AMT) exemption for taxable years 2001 through 2004 from $33,750 to $35,750 for single and head of household filers, from $45,000 to $49,000 for married taxpayers filing joint returns, and from $22,500 to $24,500 for married taxpayers filing separate returns. The income levels at which the exemptions begin to phase out, the AMT tax rates of 26 percent and 28 percent, and the income level at which the tax rate increases to 28 percent were not altered by EGTRRA. After taxable year 2004, the exemption levels revert to their pre-EGTRRA levels.

Proposal

The Administration proposes to increase the AMT exemption amount in taxable years 2003 and 2004 by $4,000 for single taxpayers and married taxpayers filing separate returns and by $8,000 for married taxpayers filing joint returns, and to maintain those higher exemption levels through taxable year 2005. Under the proposal, the AMT exemption would be $39,750 for single and head of household filers, $57,000 for married taxpayers filing joint returns, and $28,500 for married taxpayers filing separate returns.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-3,141	-8,534	-10,353	-6,931	0	0	-25,818	-25,818

TAX INCENTIVES

Provide Incentives for Charitable Giving

PROVIDE CHARITABLE CONTRIBUTION DEDUCTION FOR NON-ITEMIZERS

Current Law

Individual taxpayers who itemize their deductions may claim a deduction for contributions made to qualified charitable organizations. Total deductible contributions may not exceed 50 percent of the taxpayer's adjusted gross income (AGI), and lower deductibility limits apply in the case of contributions of appreciated property and contributions to certain private foundations. Under current law, taxpayers who elect the standard deduction ("non-itemizers") may not claim a deduction for charitable contributions.

Reasons for Change

Approximately two-thirds of tax filers are non-itemizers, and thus are not allowed to claim tax deductions for their charitable contributions. Allowing non-itemizers to deduct their charitable contributions would help increase support for charitable organizations by rewarding and encouraging giving by all taxpayers.

Proposal

Taxpayers who do not itemize would be allowed to deduct cash contributions to qualified charitable organizations in addition to claiming the standard deduction, effective for tax years beginning after December 31, 2002. Taxpayers would be allowed to deduct aggregate contributions that exceed $250 ($500 for married taxpayers filing joint returns) up to a maximum deduction of $250 ($500 for married taxpayers filing joint returns). The deduction floors and limits would be indexed for inflation after 2003.[4] Deductible contributions would be subject to existing rules governing itemized charitable contributions, such as the substantiation requirements and the percentage-of-AGI limitations. The non-itemizer deduction would not be a preference item for alternative minimum tax purposes, and would not affect the calculation of AGI.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-199	-1,358	-1,067	-1,128	1,177	-1,214	-5,944	-12,571

[4] In order to maintain the fixed relationship between the deduction floors and ceilings for single taxpayers and married taxpayers filing jointly, the dollar amounts for joint returns would be twice the indexed values for single returns.

PERMIT TAX-FREE WITHDRAWALS FROM IRAS FOR CHARITABLE CONTRIBUTIONS

Current Law

Eligible individuals may make deductible contributions to a traditional individual retirement arrangement (traditional IRA). Other individuals with taxable income may make nondeductible contributions to a traditional IRA. Earnings and pre-tax contributions in a traditional IRA are includible in income when withdrawn. Withdrawals made before age 59½ are subject to an additional 10-percent excise tax, unless an exception applies.

Individuals with adjusted gross incomes (AGI) below certain levels may make nondeductible contributions to a Roth IRA. Amounts withdrawn from a Roth IRA as a qualified distribution are not includible in income. A qualified distribution is a distribution made (1) after 5 years and (2) after the holder has attained age 59½, died, or become disabled or is made for first-time homebuyer expenses of up to $10,000. Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent the distributions are attributable to earnings, and are also subject to the 10-percent early withdrawal tax (unless an exception applies).

Individuals who itemize their deductions may claim a deduction for contributions made to qualified charitable organizations. Total deductible contributions may not exceed 50 percent of the taxpayer's AGI, and lower deductibility limits apply in the case of contributions of appreciated property and contributions to certain private foundations. Excess amounts may be carried forward and deducted in future years. In addition, the total of most categories of itemized deductions, including charitable contributions, is reduced by 3 percent of AGI in excess of a certain threshold ($137,300 for most filers in 2002).

Reasons for Change

Under current law, a taxpayer who wishes to donate otherwise taxable IRA assets to charity must first include the taxable amounts in income and then claim a deduction for charitable contributions. Because not all taxpayers can deduct the full amount of their charitable contributions, current law effectively discourages some taxpayers from contributing their IRA assets to charity. Allowing taxpayers to exclude from income direct transfers from IRAs to qualified charities will stimulate additional charitable giving by simplifying the required tax calculations and eliminating the current-law tax disincentives.

Proposal

Individuals would be allowed to exclude from gross income (and thus from AGI for all purposes under the Code) distributions made after age 65 from a traditional or Roth IRA directly to a qualified charitable organization. The exclusion would not apply to indirect gifts through a split interest entity such as a charitable remainder trust or pooled income fund, or through the purchase of a charitable gift annuity. The exclusion would be available without regard to the percentage of AGI limits that apply to deductible contributions. An amount transferred directly to a charitable organization would be counted as a distribution for purposes of the required minimum distribution rules. The exclusion for transfers to charitable organizations would apply only to the extent the individual does not receive any benefit in exchange for the transfer. No charitable deduction would be allowed with respect to any amount that is excludable from income under this provision. If an amount transferred from the IRA would otherwise be nontaxable, such as a qualified distribution from a Roth IRA or the return of nondeductible contributions from a traditional IRA, the normal charitable contribution deduction rules would apply.

The proposal would be effective for distributions after December 31, 2002.

<u>Revenue Estimate</u>

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-66	-437	-361	-376	-382	-388	-1,944	-4,076

EXPAND AND INCREASE THE ENHANCED CHARITABLE DEDUCTION FOR CONTRIBUTIONS OF FOOD INVENTORY

Current Law

A taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) the taxpayer's basis in the contributed property, plus one-half of the gain that would have been realized had the property been sold or (2) two times basis. To be eligible for the enhanced deduction, the inventory must be contributed to a charitable organization (other than a private nonoperating foundation), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with these requirements. To claim the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Reasons for Change

The lack of incentives for businesses other than C corporations (including many farmers and small businesses) to donate food inventory to charity reduces the ability of charities to combat hunger. Increasing the amount of the enhanced deduction for contributions of food inventory, making it available to any taxpayer engaged in a trade or business, and clarifying the method of determining fair market value in the case of surplus food will increase donations of food inventory.

Proposal

Eligibility for the enhanced deduction for donations of food inventory would be expanded to include businesses other than C corporations. The amount of the enhanced deduction for donations of food inventory would be increased to the lesser of: (1) fair market value, or (2) two times basis. To ensure consistent treatment of all businesses claiming an enhanced deduction for donations of food inventory, the enhanced deduction for qualified food donations by S corporations and non-corporate taxpayers would be limited to 10 percent of net income from the associated trade or business. A special provision would allow taxpayers with a zero or low basis in the qualified food donation (e.g., taxpayers that use the cash method of accounting for purchases and sales, and taxpayers that are not required to capitalize indirect costs) to assume a basis equal to 25 percent of fair market value. The enhanced deduction would be available only for donations of "apparently wholesome food" (food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations, even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions). The fair market value of "apparently wholesome food" that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market, would be determined by taking into account the price at which the same or substantially the same food items (taking into account both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

These proposed changes in the enhanced deduction for donations of food inventory would be effective for taxable years beginning after December 31, 2002.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-19	-54	-59	-66	-72	-79	-330	-872

REFORM EXCISE TAX BASED ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS

Current Law

Private foundations that are exempt from Federal income tax generally are subject to a two-percent excise tax on their net investment income. The excise tax rate is reduced to one percent in any year in which the foundation's distributions for charitable purposes exceed the average level of the foundation's charitable distributions over the five preceding taxable years (with certain adjustments). Private foundations that are not exempt from Federal income tax, including certain charitable trusts, must pay an excise tax equal to the excess (if any) of the sum of the excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. Under current law, private nonoperating foundations generally are required to make annual distributions for charitable purposes equal to at least five percent of the fair market value of the foundation's noncharitable use assets (with certain adjustments). The amount that a foundation is required to distribute annually for charitable purposes is reduced by the amount of the excise tax paid by the foundation.

Reasons for Change

The current "two-tier" structure of the excise tax on private foundation net investment income may discourage foundations from significantly increasing their distributions for charitable purposes in any particular year. Under the current formula, any increase in the foundation's percentage payout in a given year (by increasing the average percentage payout) makes it more difficult for the foundation to qualify for the reduced one percent excise tax rate in subsequent years. Eliminating the "two-tier" structure of this excise tax would ensure that private foundations do not suffer adverse excise tax consequences if they increase their grantmaking in a particular year to respond to charitable needs. Such a change would also simplify tax planning and the calculation of the excise tax for private foundations. In addition, lowering the excise tax rate for all foundations would make additional funds available for charitable purposes.

Proposal

This proposal would replace the two rates of tax on private foundations that are exempt from Federal income tax with a single tax rate of one percent. The tax on private foundations not exempt from Federal income tax would be equal to the excess (if any) of the sum of the one-percent excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic level of charitable distributions would be repealed.

The proposal would be effective for taxable years beginning after December 31, 2002.

Revenue Estimate[5]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-15	-159	-110	-115	-120	-128	-632	-1,399

[5] Estimate stacked after proposal to eliminate double taxation of corporate earnings.

MODIFY TAX ON UNRELATED BUSINESS TAXABLE INCOME OF CHARITABLE REMAINDER TRUSTS

Current law

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a non-charity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Distributions from a charitable remainder trust, which are included in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed, are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred; (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; (3) other income to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and (4) corpus (trust principal).

Charitable remainder trusts are exempt from Federal income tax. However, charitable remainder trusts lose their income tax exemption for any year in which they have unrelated business taxable income. Any taxes imposed on the trust are required to be allocated to trust corpus.

Reasons for Change

Under current law, a charitable remainder trust that has any unrelated business taxable income loses its tax-exempt status for the year. The Administration believes that imposing a tax equal to 100 percent of any unrelated business taxable income received by a charitable remainder trust is a more appropriate remedy than loss of tax exemption for the year.

Proposal

The Administration proposes to levy a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust, in lieu of removing the trust's Federal income tax exemption for any year in which unrelated business taxable income is received. The amount of the tax would be treated as paid from corpus. Therefore, the unrelated business taxable income would be considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

The proposal would be effective for taxable years beginning after December 31, 2002, regardless of when the trust was created.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-1	-3	-4	-4	-4	-4	-19	-51

MODIFY BASIS ADJUSTMENT TO STOCK OF S CORPORATIONS CONTRIBUTING APPRECIATED PROPERTY

Current Law

If an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining income tax liability. A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder. In many cases, a shareholder's basis in S corporation stock reflects the basis of the contributed property, whereas the charitable contribution deduction reflects the value of the contributed property. As a result, current law effectively prevents some S corporation shareholders from obtaining the full benefit of the charitable contribution deduction.

Reasons for Change

The proposal modifies the rules for adjusting the basis of S corporation stock to preserve the benefit of providing a charitable contribution deduction for contributions of appreciated property by an S corporation.

Proposal

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

The proposal would be effective for taxable years beginning after December 31, 2002.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-12	-11	-14	-16	-19	-72	-216

REPEAL THE $150 MILLION LIMITATION ON QUALIFIED 501(C)(3) BONDS

Current Law

The Tax Reform Act of 1986 established a $150 million limit on the volume of outstanding, non-hospital, tax-exempt bonds for the benefit of any one 501(c)(3) organization. The provision was repealed in 1997 with respect to bonds issued after August 5, 1997, at least 95 percent of the net proceeds of which are used to finance capital expenditures incurred after that date. Thus, the limitation continues to apply to bonds more than five percent of the net proceeds of which finance or refinance (1) working capital expenditures or (2) capital expenditures incurred on or before August 5, 1997.

Reasons for Change

The $150 million limitation results in complexity and provides disparate treatment depending on the nature and timing of bond-financed expenditures. Issuers must determine whether an issue consists of non-hospital bonds, and must calculate the amount of non-hospital bonds that are allocable to a particular tax-exempt organization. In addition, issuers must determine whether more than five percent of the net proceeds of each issue of non-hospital bonds finances working capital expenditures, or capital expenditures incurred on or before August 5, 1997, in order to determine whether the issue is subject to the limitation. Complete repeal of the limitation would enable private universities to utilize tax-exempt financing on a basis comparable to public universities.

Proposal

The $150 million limit on the volume of outstanding, non-hospital, tax-exempt bonds for the benefit of any one 501(c)(3) organization would be repealed in its entirety, effective for bonds issued after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
-2	-6	-9	-10	-9	-9	-43	-82

REPEAL RESTRICTIONS ON THE USE OF QUALIFIED 501(C)(3) BONDS FOR RESIDENTIAL RENTAL PROPERTY

Current Law

Interest on State or local bonds is generally excluded from gross income. However, this exclusion does not apply to private activity bonds unless a specific exemption is provided in the Code.

One type of tax-exempt private activity bond is a qualified 501(c)(3) bond. In general, an issue consists of qualified 501(c)(3) bonds if, among other things, at least 95 percent of its net proceeds are used by no person other than a 501(c)(3) organization or a State or local governmental unit. For this purpose, any activity of a 501(c)(3) organization that constitutes an unrelated trade or business is a non-qualifying use.

Current law contains a special limitation (the residential rental property limitation) under which, in general, an issue does not consist of qualified 501(c)(3) bonds if any of its net proceeds are used to provide residential rental property for family units. However, this limitation does not apply if: (1) the first use of the financed property is pursuant to the issue; (2) the property meets the low-income set-aside requirements described below for qualified residential rental projects under the exempt facility bond rules; or (3) the property is substantially rehabilitated (i.e., in general, rehabilitation expenditures must equal or exceed the owner's adjusted basis in the property) during the two-year period ending one year after the acquisition.

In addition to qualified 501(c)(3) bonds, current law authorizes the issuance of tax-exempt private activity bonds for certain exempt facilities that are owned or operated by private, for-profit entities. One type of exempt facility is a qualified residential rental project. A qualified residential rental project is a project for residential rental property if, at all times during a specified project period, the project meets one of the following requirements elected by the issuer: (1) at least 20 percent of the residential units are occupied by individuals whose income is 50 percent or less of area median gross income; or (2) at least 40 percent of the residential units are occupied by individuals whose income is 60 percent or less of area median gross income.

Reasons for Change

The residential rental property limitation results in complexity, and provides disparate treatment for new and existing property used by 501(c)(3) organizations. In applying the residential rental property limitation, issuers must first determine whether existing property is residential rental property. For example, an assisted living facility may or may not constitute residential rental property, depending in part on the amount of nursing services provided. Issuers must also determine whether existing property satisfies the low-income set-aside or rehabilitation requirements. Failure to meet the requirements could result in a loss of tax-exemption on the bonds, retroactive to the date of issue. Simplification would be achieved if the residential rental property limitation were repealed.

Proposal

The residential rental property limitation would be repealed, effective for bonds issued after the date of enactment. As under current law, the use of residential rental property by a 501(c)(3) organization would be a qualifying use only to the extent it did not constitute an unrelated trade or business.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-2	-6	-11	-17	-24	-60	-276

Strengthen and Reform Education

PROVIDE REFUNDABLE TAX CREDIT FOR CERTAIN COSTS OF ATTENDING A DIFFERENT SCHOOL FOR PUPILS ASSIGNED TO FAILING PUBLIC SCHOOLS

Current Law

The No Child Left Behind Act of 2001 amended the Elementary and Secondary Education Act of 1965 to provide that federal grant funds may be used by local educational agencies (LEAs) to provide supplemental educational services, such as tutoring and summer school, to children enrolled in a public school "identified for school improvement" for two consecutive years. These services may be provided by private entities. A school is identified for improvement after failing to make "adequate yearly progress" for two consecutive years under State-established standards. In addition, if a school is identified for improvement, LEAs must (unless prohibited by State law) provide public school choice. This means that LEAs must give students assigned to a school identified for improvement an option to transfer to another public school within the jurisdiction of the LEA, which may include a public charter school. The LEA is obligated to provide transportation to students who request such a transfer. A student who transfers is permitted to remain at that school through its highest grade, but the LEA is not obligated to provide transportation if the student's original school has improved to the point of making adequate yearly progress. Federal funds generally may not be used to pay the costs of attending a private school.

Reasons for Change

Parents of a child enrolled in a public school failing to make adequate yearly progress may conclude that transferring their child to another public school or enrolling their child in a private school is in the child's best interests. A refundable tax credit for a portion of the costs of attending a different school would reduce the financial barriers to improving such a child's educational opportunities.

Proposal

A refundable credit of 50 percent of the first $5,000 of qualifying elementary and secondary education expenses would be allowed for certain expenses incurred with respect to the enrollment or attendance in a different, qualifying school of a taxpayer's qualifying child who is a qualifying student. A qualifying child for this purpose would be one having the same principal place of abode as the taxpayer for more than one-half of the taxable year and is the taxpayer's son, daughter, stepson or stepdaughter, a sibling or stepsibling (or descendent of such individual) who the taxpayer cares for as the taxpayer's own child. An eligible foster child within the meaning used for purposes of the earned income tax credit would also qualify. Credits would be allowed for more than one qualifying child. The credit would apply against both regular and alternative minimum tax liabilities.

A qualifying student generally would be one who, under the school attendance rules and boundaries used by the LEA, attended at the close of the prior school year a public elementary or secondary school ("the local school") identified as failing to make adequate yearly progress. The identification of a school as failing to make adequate yearly progress would be made on a State-by-State basis under the terms of the No Child Left Behind Act (the Act) as of the opening day of a school year. In addition, a student who is newly assigned to a school that failed to make adequate yearly progress during the prior school year would qualify. For example, such a student attending school for the first time would qualify. Similarly, a student would qualify who, at the end of the prior school year, attended a public elementary school that made adequate progress, and was assigned as an entering student to a junior high school that had not made adequate yearly progress. A student who attended a qualifying school in one year generally would continue to qualify for additional years, even if the local school made adequate yearly progress in a subsequent year. Such a child would not qualify if he or she had a new local school (not identified as failing to make adequate yearly progress) as a result of passing into a higher grade. For example, a 6th grader who qualified because his local elementary school was designated as failing to make adequate yearly progress when he was a 5th grader would not qualify during the 7th grade if his local school for the 7th grade was a junior high school not so designated with respect to the prior year. If the local elementary school ran through the 8th grade, this student would qualify during the 6th, 7th and 8th grade even if the local school made adequate yearly progress when the student was in the 6th and 7th grades. A qualifying student at the beginning of a school year would continue to qualify for the remainder of that school year if the student moved out of the local school's attendance area but continued to attend the same qualifying school. Qualifying students would be only those in grades K – 12.

A qualifying school would be any public school (other than the local school), including a public charter school, making adequate yearly progress in the prior year or a private elementary or secondary school located in the United States. The definition of a school would be determined under State law.

Qualifying expenses would be tuition and required fees, transportation expenses, and certain other expenses incurred by the taxpayer in connection with the attendance of a qualifying student at a qualifying school. Tuition or required fees paid to a public school within the jurisdiction of the LEA in which the failing school is located would not qualify. This limitation is consistent with the LEAs obligation to provide free public education to students within its jurisdiction. Expenses that would be a qualified elementary and secondary education expense for purposes of Coverdell education savings accounts generally would also qualify. If the taxpayer's car were used to provide transportation, the expenses would be limited by the cost-per-mile allowed in connection with the use of a car for charitable activities. The additional qualifying expenses include expenditures for academic tutoring, special needs services in the case of a special needs student, books, supplies, and computer technology and equipment, as well as expenditures for room and board, uniforms, and supplementary items and services (including extended day care programs) which are required or provided by the school. In the case of a qualified school that is a home school, as defined under state law, qualifying expenses for the taxpayer would include expenditures for academic tutoring, special needs services in the case of a special needs student, books, supplies, and computer technology and equipment. No qualifying expenses for which a credit is claimed could also be treated as qualifying distributions from Coverdell educational savings accounts. Rules regarding the timing of qualifying payments would follow those used in connection with the Hope and lifetime learning credits.

Taxpayers claiming the credit would be required to provide the name and taxpayer identification number of the qualifying student and the name and address of the local school that the student would normally have attended. Further, taxpayers would be required to keep records of qualifying expenses.

LEAs would be asked to include an explanation of the availability of this tax credit as part of the dissemination of the annual reviews per section 1116(a)(C) of the Act.

The provision would be effective with respect to expenses incurred beginning with the 2003-2004 school year and through the 2007-2008 school year.

Revenue Estimate[6]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-226	-572	-752	-838	-932	-3,320	-3,818

[6] The estimate includes both receipt and outlay effects. The outlay effect for the proposal is $213 million, $543 million, $714 million, $796 million, $886 million, and $474 million in fiscal years 2004-2009, respectively. The outlay effect is $3,152 million and $3,626 million for the fiscal year 2004-2008 and 2004-2013 periods, respectively.

EXTEND, INCREASE AND EXPAND THE ABOVE-THE-LINE DEDUCTION FOR QUALIFIED OUT-OF-POCKET CLASSROOM EXPENSES

Current Law

Individual taxpayers who itemize their deductions may claim a deduction for unreimbursed, job-related expenses to the extent those expenses and other miscellaneous deductions exceed 2 percent of adjusted gross income. Such deductions may not be allowed for purposes of the alternative minimum tax.

For taxable years beginning in 2002 and 2003, taxpayers who are K-12 teachers and certain other school personnel in a school for at least 900 hours during a school year may, whether or not they itemize, deduct up to $250 incurred in connection with books, supplies, computer equipment and other equipment and supplemental materials used in the classroom.

Reasons for Change

Teachers and other school professionals often incur expenses related to classroom activities or for professional training that are not reimbursed. These expenditures enhance the quality of education received by students but diminish a teacher's properly-measured ability to pay taxes. Allowing school professionals to deduct such expenditures on their federal income tax return encourages dedicated teachers who supplement available school resources at their own expense.

Proposal

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

The provision would be effective for expenses incurred in taxable years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-23	-229	-240	-249	-260	-1,001	-2,352

Invest in Health Care

PROVIDE REFUNDABLE TAX CREDIT FOR THE PURCHASE OF HEALTH INSURANCE

Current Law

Under present law, individuals who purchase their own health insurance may claim an itemized deduction for the premiums only to the extent that the premiums, when combined with other unreimbursed medical care expenses, exceed 7.5 percent of AGI. Other medical care expenses include expenses of the taxpayer, a spouse, or a dependent for medical care, qualified long-term care services, and premiums for qualified long-term care insurance (subject to a dollar limit).

Employer-provided health insurance and reimbursements for medical care are generally excluded from gross income for income tax purposes and from wages for employment tax purposes. Active employees participating in a cafeteria plan may pay their employee share of premiums and other medical care expenses on the same pre-tax basis.

Premiums for health insurance (or an arrangement having the effect of health insurance) paid by self-employed individuals who are not eligible for subsidized employer coverage are deductible in computing AGI.

In addition, self-employed individuals and individuals employed by small employers are allowed to accumulate funds in a medical savings account (MSA) on a tax-preferred basis to pay for medical expenses, provided they are covered by a high-deductible health plan (and no other health plan).

Reimbursements made to an individual from accident or health insurance (or an arrangement having the effect of accident or health insurance) for injuries or sickness are excluded from gross income.

Finally, under the Trade Adjustment Assistance Reform Act of 2002, a refundable tax credit is provided to eligible individuals for the cost of qualified health coverage. The credit is equal to 65 percent of the amount paid by certain individuals receiving (or eligible to receive) a trade readjustment allowance or by certain individuals between the ages of 55 and 64 who are receiving pension benefits from the Pension Benefit Guaranty Corporation.

Reasons for Change

More than 40 million Americans are currently without health insurance coverage. These uninsured individuals require an incentive to assist them in purchasing health insurance. The incentive must provide assistance to low-income individuals and families with little or no income tax liability. At the same time, the incentive should not discourage individuals from entering the labor force or from earning additional income. The incentive also needs to be made available in advance and with certainty, so that uninsured individuals receive financial assistance at the same time they purchase health insurance. A health tax credit made available in advance for individuals who are not covered by public or employer-provided health plans will provide these incentives. In addition, allowing the credit to be applied to health insurance purchased through private and state purchasing groups and at state option to certain state insurance programs will enhance the tax credit's purchasing power and improve coverage options.

Proposal

The proposal would create a refundable income tax credit for the cost of health insurance purchased by individuals under age 65. The credit would provide a subsidy of up to 90 percent of the health insurance premium, up to a maximum credit of $1,000 per adult and $500 per child for up to two children. The maximum subsidy percentage of 90 percent would apply for low-income taxpayers and would be phased down at higher incomes. Individuals participating in public or employer-provided health plans would generally not be eligible for the tax credit. In addition, individuals would not be allowed to claim the credit and make a contribution to an MSA for the same taxable year.

Individuals with no dependents who file a single return and have modified AGI up to $15,000 would be eligible for the maximum subsidy rate of 90 percent and a maximum tax credit of $1,000. The subsidy percentage for these individuals would be phased down ratably from 90 percent to 50 percent between $15,000 and $20,000 of modified AGI, and then phased out completely at $30,000 of modified AGI.

All other filers with modified AGI up to $25,000 would be eligible for the maximum subsidy rate of 90 percent, and the maximum credit of $1,000 per adult and $500 per child for up to two children. The subsidy percentage would be phased out ratably between $25,000 and $40,000 of modified AGI in the case of a policy covering only one adult, and between $25,000 and $60,000 of modified AGI in the case of a policy or policies covering more than one adult. The maximum credit for these other filers would vary by income and the number of adults and children covered by a policy. For example, the maximum tax credit would equal $3,000 for families with modified AGI up to $25,000 who obtain a policy covering two adults and two or more children.

The maximum allowable premium for credit purposes would be $1,111 for an adult and $556 for a child at all income levels. These dollar amounts would be indexed by the medical care component of the Consumer Price Index based on all urban consumers.

Examples of the maximum credit:

(1) Individuals with No Dependents Filing a Single Return

Modified AGI	$15,000	$20,000	$30,000
Maximum Credit	$1,000	$556	$0

(2) Other Filers Obtaining a Policy Covering Only One Adult

Modified AGI	$25,000	$30,000	$40,000
Maximum Credit	$1,000	$667	$0

(3) Other Filers Obtaining a Policy Covering Two Adults

Modified AGI	$25,000	$40,000	$60,000
Maximum Credit	$2,000	$1,143	$0

(4) Other Filers Obtaining a Policy Covering Two Adults and One Child

Modified AGI	$25,000	$40,000	$60,000
Maximum Credit	$2,500	$1,429	$0

(5) Other Filers Obtaining a Policy Covering Two Adults and Two or More Children

Modified AGI	$25,000	$40,000	$60,000
Maximum Credit	$3,000	$1,714	$0

Individuals could claim the tax credit for health insurance premiums paid as part of the normal tax-filing process. Alternatively, the tax credit would be available in advance at the time the insurance is purchased. Individuals would reduce their premium payment by the amount of the credit and the health insurer would be reimbursed by the Department of the Treasury for the amount of the advance credit. Eligibility for the advance credit would be based on the individual's prior year tax return.

Eligible health insurance plans would be required to meet minimum coverage standards, including coverage for high medical expenses. In addition to the non-group insurance market, qualifying health insurance could also be purchased through private purchasing groups, state-sponsored insurance purchasing pools and state high-risk pools. At state option, effective after December 31, 2004, the tax credit would be allowed for certain individuals not otherwise eligible for public health insurance programs to buy into privately contracted state sponsored purchasing groups (such as Medicaid or SCHIP purchasing pools for private insurance or state government employee programs for states in which Medicaid or SCHIP does not contract with private plans.) States could, under limited circumstances, provide additional contributions to individuals who purchased private insurance through such purchasing groups. The maximum state contribution would be $2,000 per adult for up to two adults for individuals with incomes up to 133 percent of poverty. The maximum state contribution would phase down ratably reaching $500 per adult at 200 percent of poverty. Individuals with income above 200 percent of poverty would not be eligible for a state contribution. States would not be allowed to provide any other explicit or implicit cross subsidies.

The health insurance tax credit would be effective for taxable years beginning after December 31, 2003, and would be available in advance beginning July 1, 2005.

Revenue Estimate[7]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-324	-4,995	-9,055	-9,660	-9,966	-34,000	-89,158

[7] The estimate includes both receipt and outlay effects. The outlay effects are $3,546 million for 2005, $8,166 million for 2006, $9,251 million for 2007, $9,827 million for 2008, $10,549 million for 2009, $10,934 million for 2010, $11,365 million for 2011, $11,765 million for 2012, $12,205 million for 2013, $30,790 million for 2004-2008, and $87,608 million for 2004-2013.

PROVIDE AN ABOVE-THE-LINE DEDUCTION FOR LONG-TERM CARE INSURANCE PREMIUMS

Current Law

Under present law, the tax treatment of long-term care insurance premiums depends on whether an individual has medical expenses that exceed a certain threshold, whether the individual is covered under a qualified long-term care insurance plan paid for by an employer, and whether an individual has self-employment income.

Individuals who purchase their own qualified long-term care insurance may claim an itemized deduction for the premiums, up to certain dollar limits that are based on age, but only to the extent that the premiums, when combined with other unreimbursed medical care expenses, exceed 7.5 percent of AGI.

For self-employed individuals who are not eligible for subsidized employer long-term care insurance coverage, premiums paid for qualified long-term care insurance (up to the applicable dollar limit) are deductible in determining AGI and, thus, are not limited by the 7.5 percent of AGI applying to other individuals.

Employer-provided qualified long-term care insurance coverage and reimbursements for qualified long-term care services generally are excluded from gross income for income and employment tax purposes.

Reimbursements made to an individual from qualified long-term care insurance are generally excluded from gross income, regardless of whether the insurance is purchased by the individual or by the individual's employer.

Reasons for Change

Favorable tax treatment for the purchase of long-term care insurance generally provides an incentive for individuals to take greater financial responsibility for their long-term care needs. Allowing all individuals to deduct the cost of purchasing long-term care insurance will encourage the use of long-term care insurance. With the incorporation of tax deductibility for policies that meet eligibility standards, quality long-term care insurance will play a larger role in the financial security of older Americans.

Proposal

The proposal would allow individuals purchasing qualified long-term care insurance a deduction in determining AGI up to the annual dollar limitations that currently apply to the deductibility of long-term care insurance. The deduction would be available for the employee's share of the cost of employer-provided coverage if the employee pays at least 50 percent of the cost. In addition, qualified long-term care insurance policies would be required to meet new minimum standards for quality coverage.

The deduction would be effective for taxable years beginning on or after January 1, 2004, but would be phased in so that 25 percent of the premium would be deductible for 2004, 35 percent for 2005, 65 percent for 2006, and 100 percent for 2007 and thereafter.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-112	-559	-984	-1,923	-3,063	-6,641	-28,255

ALLOW UP TO $500 IN UNUSED BENEFITS IN A HEALTH FLEXIBLE SPENDING ARRANGEMENT TO BE CARRIED FORWARD TO THE NEXT YEAR

Current Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for qualified benefits. An FSA for medical care (or other qualified benefits) may be part of a salary reduction cafeteria plan. Under such a plan, an employee reduces current compensation and the employer agrees to provide the employee with qualified benefits. If the arrangement meets the cafeteria plan requirements of section 125, the compensation that was available is not included in the employee's gross income or wages for employment tax purposes. Section 125 prohibits cafeteria plans from providing deferred compensation. Proposed regulations under section 125 include rules that prevent FSAs from being used to provide deferred compensation, and require that FSAs have risk-shifting and risk-distribution characteristics similar to traditional health insurance. These rules include a "use it or lose it" provision that prevents the carry forward to future years of amounts in a cafeteria plan that are not used for medical expenses incurred by the end of a year.

Reasons for Change

Participation in FSAs can help employees to save for unexpected medical expenses. Requiring employees to forfeit the entire FSA account balance that has not been used at the end of the year discourages the use of FSAs. Further, without the ability to carry forward small amounts, employees may accelerate expenses or incur unnecessary costs (e.g., extra eyeglasses) as year end approaches in order to avoid forfeiting benefits. Modifying the "use it or lose it" rule to allow a limited carryforward will encourage saving for unexpected medical expenses and reduce the incentive to accelerate expenses or incur unnecessary costs, while preserving the character of a cafeteria plan health FSA as an arrangement that provides current health insurance coverage.

Proposal

An employer's cafeteria plan health FSA could permit up to $500 in amounts available for an employee's medical expenses but not used during the plan year to be carried forward to the employee's account for the next plan year of the health FSA.

The proposal would be effective for plan years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-367	-640	-723	-782	-830	-3,342	-8,385

PROVIDE ADDITIONAL CHOICE WITH REGARD TO UNUSED BENEFITS IN A HEALTH FLEXIBLE SPENDING ARRANGEMENT

Current Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for qualified benefits. An FSA for medical care (or other qualified benefits) may be part of a salary reduction cafeteria plan. Under such a plan, an employee reduces current compensation and the employer agrees to provide the employee with qualified benefits. If the arrangement meets the cafeteria plan requirements of section 125, the compensation that was available is not included in the employee's gross income or wages for employment tax purposes. Section 125 prohibits cafeteria plans from providing deferred compensation. Proposed regulations under section 125 include rules that prevent FSAs from being used to provide deferred compensation, and require that FSAs have risk-shifting and risk-distribution characteristics similar to traditional health insurance. These rules include a "use it or lose it" provision that prevents the carry forward to future years of amounts in a cafeteria plan that are not used for medical expenses incurred by the end of a year.

Reasons for Change

Participation in FSAs can help employees to save appropriately for unexpected medical expenses. Requiring employees to forfeit the FSA account balance that has not been used at the end of the year discourages the use of FSAs. A related proposal would allow cafeteria plans to permit employees to carry forward up to $500 in unused amounts within the FSA. Also allowing employers to give participants the option of receiving a distribution of up to $500 in unused amounts or the option of contributing this amount to the employer's retirement plan or to an Archer Medical Savings Account (MSA) would further encourage participation. These options provide additional flexibility for employees participating in FSAs who would not benefit from the carryforward, such as participants terminating employment with the employer.

Proposal

An employer's cafeteria plan could permit up to $500 in amounts available but not used for medical expenses during the plan year to be distributed to the employee or contributed to a 401(k) plan, 403(b) plan, governmental 457(b) plan, SARSEP, SIMPLE IRA, or MSA. Amounts distributed would be subject to income tax withholding and employment taxes. Amounts the participant chooses to contribute to a 401(k) or other plan or MSA would be subject to the normal rules (e.g., contribution limits, discrimination tests, withdrawal restrictions, employment taxes) applicable to elective contributions to the receiving plan or MSA.

The proposal would be effective for plan years beginning after December 31, 2003.

Revenue Estimates

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-19	-33	-39	-45	-52	-188	-595

PERMANENTLY EXTEND AND REFORM ARCHER MEDICAL SAVINGS ACCOUNTS

Current Law

An MSA is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for medical expenses. An individual is eligible to establish an MSA only if the employee (or the employee's spouse) is covered by a high deductible health plan (and no other health plan) and is either self-employed or employed by a small employer maintaining the high deductible health plan. Generally, if more than 750,000 individuals establish an MSA before 2003, no additional MSAs may be established. MSAs may not be established after December 31, 2003.

A high deductible health plan is defined as a health plan with an annual deductible in the range of $1,700 to $2,500 in the case of individual coverage and in the range of $3,350 to $5,050 in all other cases. Generally, no coverage of medical services is permitted under an MSA plan before the deductible is met. A high deductible health plan must also have an out-of-pocket limit that is no higher than $3,350 in the case of individual coverage and $6,150 in all other cases.

Individual contributions to an MSA that do not exceed specified limits are deductible in determining AGI and employer contributions to an MSA are excludable up to those same limits. An individual who receives an employer contribution for a year is not allowed to make a deductible contribution for the same year. In addition, contributions to an MSA are not permitted under a cafeteria plan. The annual limit on MSA contributions is 65 percent of the annual deductible in the case of individual coverage and 75 percent of the annual deductible all other cases.

Earnings on an MSA are not includible in income. Distributions from an MSA that are used to pay medical expenses are generally excludable from income. If a distribution is not for purposes of paying medical expenses, the distribution is includible in income and subject to a 15-percent additional tax. Amounts distributed after an account holder reaches age 65, dies or becomes disabled are not subject to this 15-percent additional tax.

Reasons for Change

MSAs provide an additional option for individuals, including those currently without health insurance, to purchase coverage and give individuals more control over spending on medical expenses. This control provides an incentive for individuals to become more cost conscious purchasers of medical services, potentially reducing the growth of health care costs. Making MSAs permanent would make the MSA market a more viable option. Eliminating restrictions on the availability of MSAs and easing some of the restrictions on MSA plan features would simplify the rules, make MSA qualified health insurance more like policies available in the health insurance market today, and make the use of these accounts attractive to more individuals.

Proposal

MSAs would be made permanent and liberalized. The 750,000 cap on the number of MSAs and the restriction related to employer size would be removed. All employees and individuals covered by a high deductible health plan, other than a health plan for which the individual is eligible to claim a refundable health care credit, would be eligible for MSAs. The definition of high deductible health plan would be modified to permit an annual deductible as low as $1,000 for individual coverage and $2,000 in all other cases. Such plans would also be permitted to provide, without counting against the deductible, up to $100 of coverage for allowable preventive services per covered individual each year.

The maximum limit on MSA contributions would be increased to 100 percent of the annual deductible. Both employers and employees would be permitted to make contributions up to the applicable limit for an individual during a particular year. Contributions to MSAs would be permitted to be made through a cafeteria plan.

The proposal would be effective for taxable years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-26	-284	-432	-486	-549	-1,777	-5,134

PROVIDE AN ADDITIONAL PERSONAL EXEMPTION TO HOME CAREGIVERS OF FAMILY MEMBERS

Current Law

Taxpayers are allowed to claim exemptions for themselves, their spouses and their dependents. To qualify as a dependent, an individual must (1) be a specified relative or member of the taxpayer's household for a full year,[8] (2) receive over half of his or her support from the taxpayer,[9] (3) not have gross income in excess of the exemption amount,[10] (4) be a citizen or resident of the United States or resident of Canada or Mexico, and (5) not be required to file a joint tax return with his or her spouse.

In 2003, the amount of the exemption is $3,050. Personal exemptions are phased-out by two percentage points for each $2,500 ($1,250 if married filing separately) or fraction thereof by which adjusted gross income exceeds certain thresholds ($139,500 for single filers, $209,250 for joint filers, $174,400 for heads of households, and $104,625 for married couples filing separate returns). Both the amount of the exemption and the income thresholds at which the exemption begins to phase out are indexed for inflation.

Reasons for Change

A parent's long illness or disability can impose significant burdens on their adult children who choose to care for them at home. Similar burdens are incurred by taxpayers who are the primary caregivers for their ill or disabled spouses or grandparents. Taxpayers who provide long-term care in their own home for close family members incur significant costs, and therefore do not have the same ability to pay as other taxpayers. Providing an additional exemption adjusts for differences in ability to pay between caregivers and other taxpayers and recognizes the formal and informal costs of providing long-term care.

Proposal

Taxpayers would be eligible to claim an additional personal exemption for certain qualified family members residing with the taxpayer in the household the taxpayer maintains. A taxpayer would be treated as maintaining the household for the year only if over half the cost of maintaining the household for the year is furnished by the taxpayer. Qualified family members would include any individual with long-term care needs who (1) is the spouse of the taxpayer or an ancestor of the taxpayer (or, if married, the taxpayer's spouse) or the spouse of such an ancestor and (2) is a member of the taxpayer's household for the entire year. An individual would be considered to have long-term care needs if he or she were certified by a licensed physician (prior to the filing of a return claiming the exemption) as being unable for at least 180 consecutive days to perform at least two activities of daily living (ADLs) without substantial

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8 Specified relatives include the taxpayer's sons, daughters, grandchildren, siblings, parents, aunts, uncles, nieces and nephews.

9 For purposes of determining whether a taxpayer provides over half of an individual's support, public assistance payments are taken into account as support payments made by a governmental authority.

10 This test does not apply if the dependent is the taxpayer's child (son, daughter, stepson, or stepdaughter or foster child) and is under the age of 19 at the close of the calendar year (24 if a full-time student).

assistance from another individual, due to a loss of functional capacity.[11] As under Internal Revenue Code section 7702B(c)(2)(B), ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

As an alternative to the two-ADL test described above, an individual would be considered to have long-term care needs if he or she were certified by a licensed physician as, for at least 180 consecutive days, (1) requiring substantial supervision to be protected from threats to health and safety due to severe cognitive impairment and (2) being unable to perform at least one ADL or, to the extent provided in regulations prescribed by the Secretary of the Treasury (in consultation with the Secretary of Health and Human Services), being unable to engage in age appropriate activities.

The taxpayer would be required to provide a correct taxpayer identification number for the individual with long-term care needs, as well as a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying physician. Failure to provide correct taxpayer and physician identification numbers would be subject to mathematical error procedures (enabling the Internal Revenue Service to summarily assess additional tax without issuing a notice of deficiency). Further, the taxpayer could be required to provide other proof of the existence of long-term care needs in such form and manner, and at such times, as the Secretary requires.

The proposal would be effective for taxable years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-70	-465	-437	-422	-417	-1,811	-3,892

[11] A portion of the period certified by the physician must occur within the taxable year for which the exemption is claimed. After the initial certification, individuals must be re-certified by their physician within three years or such other period as the Secretary prescribes.

ALLOW THE ORPHAN DRUG TAX CREDIT FOR CERTAIN PRE-DESIGNATION EXPENSES

Current Law

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States (so-called "orphan drugs"). Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration (FDA) in accordance with the section 526 of the Federal Food, Drug, and Cosmetic Act. Research expenses claimed for the Orphan Drug Credit are not eligible for the research credit.

Reasons for Change

Currently, expenditures for human clinical trials are eligible for the credit only after the FDA designates the drug as a potential treatment for a rare disease or condition. Expenses for clinical trials that the taxpayer undertakes while FDA reviews the taxpayer's application for designation are ineligible. This creates an incentive to defer clinical testing for orphan drugs until the taxpayer receives FDA's approval and complexity for taxpayers by treating pre-designation and post-designation clinical expenses differently. The proposal would reduce the incentive to defer clinical testing while FDA reviews the taxpayer's application for designation of a drug as an orphan drug and simplify the credit by treating pre-designation expenses and post-designation expenses equally.

Proposal

Taxpayers that incur expenses prior to FDA designation would be permitted to claim the Orphan Drug Credit for these expenses when the drug receives FDA designation as a potential treatment for a rare disease or condition. The taxpayer would be permitted to claim the credit for pre-designation costs either in the year of approval, or to file an amended return to claim the credit for prior years.

The proposal would be effective for qualified expenses incurred after December 31, 2002.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-*	-*	-1	-1	-1	-3	-8

* less than .5 million.

Encourage Telecommuting

EXCLUDE FROM INCOME THE VALUE OF EMPLOYER-PROVIDED COMPUTERS, SOFTWARE AND PERIPHERALS

Current Law

The value of computers, software and other office equipment provided by an employer to an employee for use at the employee's home is generally excludable from income to the extent that the employee uses the equipment to perform work for the employer, and includible in income to the extent that the employee uses the equipment for personal purposes or to carry on a trade or business other than working as an employee of the employer.

Reasons for Change

Current law imposes significant recordkeeping requirements on employers and their workers who use employer-provided computer equipment and services to telecommute. These requirements encourage noncompliance and raise the cost of telecommuting. Removing these requirements would lower the costs of telecommuting, benefiting workers, their families and the environment.

Proposal

An individual would be allowed to exclude from income the value of any computers, software or other office equipment provided by such individual's employer if the equipment is necessary for the individual to perform work for the employer at home.[12] The employee would be required to make substantial business use of the equipment to perform work for the employer. Substantial business use would include standby use for periods when work from home may be required by the employer, such as during work closures caused by the treat of terrorism, inclement weather, or natural disasters. The exclusion would apply to all use of such equipment, including use by the employee for personal purposes or to carry on a trade or business other than working as an employee of the employer.

The proposal would be effective for taxable years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
($'s in millions)							
0	-35	-51	-53	-54	-56	-249	-554

[12] If the employer provided the employee with use of equipment after the end of the equipment's depreciable life, the value of such use to the employee would be deemed to be zero.

Increase Housing Opportunities

PROVIDE TAX CREDIT FOR DEVELOPERS OF AFFORDABLE SINGLE-FAMILY HOUSING

Current Law

No tax credits are available to developers of new or rehabilitated, affordable single-family housing. Current law does provide tax credits to owners of qualified low-income rental units through the low-income housing tax credit (LIHTC). The LIHTC may be claimed over a 10-year period for a portion of the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not federally subsidized is adjusted monthly by the Internal Revenue Service so that generally the 10 annual credit amounts have a present value of 70 percent of qualifying costs. The credit percentage for substantially rehabilitated housing that is federally subsidized and for existing buildings is calculated to have a present value of 30 percent of qualified expenditures. For 2002, the aggregate first-year credit authority allocated to each State was the greater of $2 million or $1.75 per capita. These amounts are indexed for inflation beginning in 2003. Tax credits are allocated to particular projects by State or local housing agencies pursuant to publicly announced plans for allocation. Authority to allocate credits may be carried forward by agencies to the following calendar year. Unused credit allocations may be returned to an agency for reallocation. Credit allocations may revert to the agency if less than 10 percent of the taxpayer's reasonably expected qualifying basis is expended within 6 months of receiving the allocation. Authority not used in a timely manner reverts to a national pool for distribution to States requesting additional authority. Agencies may award less than the maximum credits generally applicable. Generally, a qualifying building must be placed in service in the year the credit is allocated unless at least 10 percent of the taxpayer's reasonably expected basis in the property is expended in the year of allocation or within 6 months of the allocation date. Rules are provided for the allocation of costs to individual units in multi-unit projects and to property that is part of a project but used for purposes other than rental housing. The tax credit period begins with the taxable year in which qualified buildings are placed in service (or, in certain circumstances, the succeeding taxable year). Credits are recaptured if the required number of units is not rented to qualifying tenants for a period of 15 years.

Current law allows tax-exempt bonds (mortgage revenue bonds) to be issued by State and local governments to finance mortgages at interest rates that are below-market for homebuyers who meet certain income and purchase price limits. In general, eligible individuals must be first-time homebuyers and have incomes of 115 percent (100 percent for families with less than 3 members) or less of the greater of area or statewide median gross income (applicable median family income). The subsidy is recaptured under certain conditions if the home is sold within 9 years of the date of purchase.

Reasons for Change

The quality of life in distressed neighborhoods can be improved by increasing home ownership. Existing buildings in these neighborhoods often need extensive renovation before they can provide decent owner-occupied housing. Renovation may not occur because the costs involved exceed the prices at which the housing units could be sold. Similarly, the costs of new construction may exceed their market value. Properties will sit vacant and neighborhoods will remain blighted unless the gap between development costs and market prices can be filled.

Proposal

The proposal would create a single-family housing tax credit (SFHTC). First-year credit authority of amounts equal to LIHTC allocations would be made available annually to States (including U.S. possessions) beginning in calendar year 2004. Pursuant to a plan of allocation, State or local housing credit agencies would award first-year credits to new or rehabilitated housing units comprising a project for the development of single-family housing in census tracts with median incomes of 80 percent or less of the greater of area or statewide median income, or in areas of chronic economic distress (following rules similar to those used in connection with mortgage revenue bonds) designated within the 5 years prior to allocation. Rules similar to the current law rules for the LIHTC would apply regarding carry forward and return of unused credits and a national pool for unused credits. Units in condominiums and cooperatives could qualify as single-family housing. Credits would be awarded as a fixed amount for individual units comprising a project. The present value of the credits with respect to a unit, as of the beginning of the credit period (described below), could not exceed 50 percent of the eligible basis of the unit. For these purposes, present value would be determined based on the mid-term Applicable Federal Rate in effect for the date the agency allocated credits to the project. Rules similar to the current law rules for the LIHTC would apply to determine eligible basis of individual units. Neither land nor existing structures would be included in eligible basis. Units in rehabilitated structures would qualify only if rehabilitation expenditures exceeded $25,000. The taxpayer (developer or investor partnership) owning the housing unit immediately prior to the date of sale to a qualified buyer (or, if later, the date a certificate of occupancy was issued) would be eligible to claim SFHTCs over a 5-year period beginning on that date. No credits with respect to a housing unit would be available unless the unit was sold within a 1-year period beginning on the date a certificate of occupancy is issued with respect to that unit.

Eligible homebuyers would have incomes at 80 percent (70 percent for families with less than 3 members) or less of applicable median family income. They would not have to be first-time homebuyers. Rules similar to the mortgage revenue bond provisions would apply to determine applicable median family income. As in the case of mortgage revenue bonds, homebuyers would be subject to recapture provisions in certain circumstances. In particular, recapture rules would apply if the homebuyer (or a subsequent buyer) sold the property to a nonqualified buyer within 3 years of the date of initial sale of the unit. The recapture amount would equal half the gain resulting from the resale, reduced by 1/36th of that gain for each month between the initial sale and the sale to a nonqualified buyer. The recapture amount would be paid to the agency making the credit allocation pursuant to a lien for this purpose recorded at the time of initial purchase. No recapture provision would apply to taxpayers eligible to claim SFHTCs. If a housing unit for which any credit is claimed were converted to rental property by the initial homebuyer within the first 3 years following the purchase, no deductions could be claimed.

The proposal would be effective beginning with first-year credit allocations for calendar year 2004. The Treasury Department would have the authority to promulgate necessary reporting requirements.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-7	-78	-315	-750	-1,316	-2,466	-16,133

Encourage Saving

ESTABLISH INDIVIDUAL DEVELOPMENT ACCOUNTS (IDAS)

Current Law

Under section 25B, certain low-income taxpayers are allowed a non-refundable credit for qualified retirement savings contributions up to $2,000. The maximum credit rate is 50 percent and is phased out for single filers with adjusted gross income between $15,000 and $25,000 ($22,500 and 37,500 for head of households and $30,000 and $50,000 for joint returns). The credit does not apply to contributions made after December 31, 2006. No other current tax provision is specifically targeted to encourage low-income families to save and develop a pool of capital to be used for purposes such as a first-time home purchase, higher education expenses, or small business capitalization.

IDAs were first authorized under the Personal Work and Responsibility Act of 1996. The Assets for Independence Act of 1998 established a five-year IDA demonstration program, with an annual appropriation of $25 million. Under the program, which the Department of Health and Human Services administers, an IDA can be opened by certain individuals who meet a net worth test and are eligible for the Earned Income Tax Credit or for Temporary Assistance for Needy Families (the successor to AFDC). Individuals' contributions are not deductible but are matched by contributions from a program run by a state or a participating nonprofit organization. The matching contributions and their earnings are not taxable to the individual. Withdrawals can be made for higher education, first-home purchase, or small business capitalization. Matching amounts are typically held separately, and withdrawals must be paid directly to a mortgage provider, institution of higher education, or business capitalization account at a financial institution. Match rates chosen by the state or nonprofit must be between 50 and 400 percent.

Reasons for Change

One third of all Americans have no assets available for investment, and another fifth have only negligible assets. The United States household savings rate lags far behind other industrial nations, constraining national economic growth and keeping many Americans from entering the economic mainstream by buying a house, obtaining an adequate education, or starting a business.

To ameliorate this situation by establishing IDA programs more broadly, federal support is needed both for the matching funds and for the administrative costs of the programs. In addition, financial education is an essential component of a policy to assist lower-income persons in building assets. By helping program sponsors to defray the costs associated with matching participants' contributions, administering the accounts, and providing financial education, the credit will both stimulate savings and encourage a sensible approach to lifetime financial planning.

Proposal

The Administration's proposal would create a tax credit, subject to the provisions of the General Business Credit, to defray the cost of establishing and running IDA programs, contributing matching funds to the appropriate accounts, and providing financial education to account holders. Program sponsors could be qualified financial institutions, qualified nonprofits, or qualified Indian tribes, but the accounts would have to be held by an institution eligible under current law to serve as the custodian of IRAs. The goals and broad outline of this program are similar to those of the IDA demonstration program; however, certain specific design features are intended to facilitate administration through the tax system.

Individuals between the ages of 18 and 60 who are not dependents or students and meet certain income requirements would be eligible to establish and contribute to an IDA. For single filers, the income limit would be $20,000 in modified AGI. The corresponding thresholds for head-of-household and joint filers would be $30,000 and $40,000 respectively. (Married individuals filing separately could not participate.) Modified AGI is AGI as ordinarily computed, plus certain exempt items. In all cases eligibility would be determined by the individual's circumstances for the previous taxable year. Eligibility limits would be indexed annually for inflation beginning in 2005. Sponsors would match contributions from eligible account holders on a dollar-for-dollar basis up to $500 per year. The main account (including earnings) and an account containing the matching amounts (including earnings) would be tracked separately by the sponsor.

Program sponsors (and, if the sponsor is exempt, other persons as provided in regulations) could claim a tax credit for an IDA program. The credit would have two components: First, a $50-per-account credit could be claimed each year to offset the ongoing costs of maintaining and administering each account and providing financial education to participants. Except for the first year that an account is open, the credit would be available only for accounts with a balance at year's end of more than $100. In addition, there is a credit for the dollar-for-dollar matching amounts.

Participants could generally withdraw their contributions and matching funds (including earnings) for qualified purposes, which include certain higher education expenses, first-time home purchase expenditures, and small business capitalization. The financial institution at which the IDA is held would generally be required to disburse the funds directly to another financial institution (in cases of home purchase or business start-up) or to an institution of higher education. Non-qualified distributions could not be made from the account containing the matching funds (including earnings). Non-qualified withdrawals from the account containing the participant's contributions could result in the forfeiture of some or all of the amounts in the matching-fund account. Matching funds and earnings would generally be available, without penalty, to the account holder for any purpose after he or she attains the age of 61.

Contributions to IDAs by individuals would not be deductible, and the earnings on the contributions would be taxable to the account holder. Matching amounts and earnings on those amounts would not be taxable to the account holder at any time.

The proposal includes explicit regulatory authority for Treasury to adopt rules to permit IDA program sponsors to verify the eligibility of individuals seeking to open accounts and to ensure that these individuals have not previously opened such an IDA. The authority would also extend to rules governing the recapture of credits claimed with respect to non-eligible individuals and with respect to matching amounts and earnings that are forfeited.

The credit would apply with respect to the first 900,000 IDA accounts opened before January 1, 2010, and with respect to matching funds for participant contributions that are made after December 31, 2004, and before January 1, 2012. The credit could generally be claimed for taxable years ending after December 31, 2004, and beginning before January 1, 2012.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	0	-124	-267	-319	-300	-1,010	-1,347

Protect the Environment

PERMANENTLY EXTEND EXPENSING OF BROWNFIELDS REMEDIATION COSTS

Current Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement of hazardous substances at a qualified contaminated site (so-called "brownfields"). This provision applies only to expenditures paid or incurred before January 1, 2004.

Hazardous substances are defined generally for purposes of the brownfields provision by reference to sections 101(14) and 102 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA). A qualified contaminated site generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) contains (or potentially contains) a hazardous substance; and (3) is certified by the appropriate state environmental agency as to the presence (or potential presence) of a hazardous substance. However, sites that are identified on the national priorities list under CERCLA do not qualify as qualified contaminated sites.

Reasons for Change

The Administration believes that encouraging environmental remediation is an important national goal. The brownfields provision encourages the cleanup of contaminated brownfields, thereby enabling them to be brought back into productive use in the economy and mitigating potential harms to public health. Extending the special treatment accorded to brownfields on a permanent basis would remove doubt among taxpayers as to the future deductibility of remediation expenditures and would promote the goal of encouraging environmental remediation.

Proposal

The expensing of brownfield remediation expenditures would be made permanent by eliminating the restriction that qualified expenditures must be paid or incurred before January 1, 2004.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-185	-282	-268	-257	-248	-1,240	-2,356

EXCLUDE 50 PERCENT OF GAINS FROM THE SALE OF PROPERTY FOR CONSERVATION PURPOSES

Current Law

A taxpayer who sells property must generally recognize, and pay taxes on, the full amount of any gain realized, even if the property is an interest in environmentally sensitive land or water and the sale is to an entity that will protect the land or water from development. By contrast, to encourage donations for conservation purposes, tax law provides a charitable contribution deduction not only for gifts to charity of a taxpayer's entire interest in property but also for conservation-oriented donations of partial interests, such as remainder interests and conservation easements. A charitable contribution deduction may also be available in certain cases where the property is sold to a charity for less than its fair market value (that is, a "bargain sale"). In some cases, if a qualified conservation easement has been donated, land burdened by that easement may receive a reduced valuation for estate tax purposes.

Reasons for Change

Some landowners may want their land to be protected for conservation purposes but cannot afford simply to donate either the land or an easement on the land, especially if the land is the landowner's primary salable asset. By adding an incentive for sales to qualified conservation groups, the current proposal complements the existing provisions that encourage charitable donations. This proposal would encourage the sale of appreciated, environmentally sensitive land and land rights to qualified conservation groups, thus achieving conservation goals through voluntary sales of property, rather than imposing government regulation on land use. The proposal would achieve this goal by strengthening the ability of conservation groups to compete with other potential buyers of appreciated, environmentally sensitive land.

Proposal

When land (or an interest in land or water) is voluntarily sold for conservation purposes (as defined below), only 50 percent of any capital gain would be included in the seller's income. The exclusion would be computed without regard to improvements. To be eligible for the partial exclusion, the sale must be to a qualified conservation organization. A qualified conservation organization is either a governmental unit or a charity that is a qualified organization under section 170(h)(3) and that is organized and operated primarily for conservation purposes. Conservation purposes means the preservation of land areas for outdoor recreation by, or the education of, the general public; the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or the preservation of open space where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy.

The buyer must provide a written statement representing that it is a qualified conservation organization and that it intends to hold the property exclusively for conservation purposes and not to transfer it for valuable consideration other than to a qualified conservation organization in a transaction that would qualify for this 50 percent exclusion if the buyer/transferor were taxable. The partial exclusion would not be available for sales pursuant to a condemnation order but would apply to any gain recognized in a sale that is made in response to the threat or imminence of such an order. If the property sold is less than the taxpayer's entire interest in the property, it must satisfy requirements like those applicable to qualified conservation contributions under section 170(h). In addition, the taxpayer or a member of the taxpayer's family must have owned the property sold for the three years immediately preceding the date of the sale.

To prevent abuse, significant penalties would be imposed on any subsequent transfer or use of the property other than exclusively for conservation purposes, or any subsequent removal of a conservation restriction contained in an instrument of conveyance of the property.

Sales of property under this provision at a price that is less than the fair market value of the property may qualify as bargain sales, but only to the extent that the proceeds of the sale, net of capital gains taxes under this provision, are lower than the after-tax proceeds that would have resulted if the property had been sold at fair market value and the seller had paid tax on the full amount of the resulting gain.

The provision would be effective for sales taking place on or after January 1, 2004.

Revenue Estimate[13]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-19	-39	-41	-42	-44	-185	-447

[13] The revenue estimate shown differs from the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004.*

Increase Energy Production and Promote Energy Conservation

EXTEND AND MODIFY THE TAX CREDIT FOR PRODUCING ELECTRICITY FROM CERTAIN SOURCES

Current Law

Current law provides taxpayers a 1.5-cent-per-kilowatt-hour tax credit for electricity produced from wind, "closed-loop" biomass (organic material from a plant that is planted exclusively for purposes of being used at a qualified facility to produce electricity), and poultry waste. The credit amount is indexed for inflation after 1992 and was 1.8 cents per kilowatt hour in 2002. The electricity must be sold to an unrelated third party and the credit is limited to the first 10 years of production. In addition, the credit is reduced if the facility producing the electricity is financed by governmental grants or subsidized energy financing, tax-exempt bonds, or other tax credits (governmental financing). The percentage reduction in the credit is the same as the governmental financing percentage of the total capital cost of the facility. The credit applies only to facilities that are owned by the taxpayer claiming the credit and that are placed in service before January 1, 2004.

Reasons for Change

The tax credit helps make electricity produced from wind and biomass competitive with other forms of electricity. These renewable energy sources will be an important part of the Nation's long-term energy supply. Expanding eligible biomass sources would increase the production of electricity from biomass.

Proposal

The credit for electricity produced from wind and biomass (but not poultry waste) would be extended for two years to facilities placed in service before January 1, 2006. In addition, eligible biomass sources would be expanded to include (i) closed-loop biomass and (ii) any solid, nonhazardous, cellulosic waste material that is segregated from other waste materials and is derived from: (a) any of the following forest-related resources: mill residues, pre-commercial thinnings, slash and brush, but not including old growth timber or wood waste incidental to pulp and paper production; (b) waste pallets, crates, and dunnage, and landscape or right-of-way tree trimmings, but not including unsegregated municipal solid waste (garbage) and post-consumer waste paper; or (c) agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop byproducts or residues. In addition, the rules relating to governmental financing would be modified. There would be no percentage reduction in the credit for governmental financing attributable to tax-exempt bonds. Instead, such financing would reduce the credit only to the extent necessary to offset the value of the tax exemption.

Special rules would apply to facilities placed in service before January 1, 2003. Electricity produced at such facilities from newly eligible sources would be eligible for the credit only from January 1, 2003, through December 31, 2005. The credit for such electricity would be computed at a rate equal to 60 percent of the generally applicable rate.

Electricity produced from newly eligible biomass co-fired in coal plants would be eligible for the credit only from January 1, 2003, through December 31, 2005. The credit for such electricity would be computed at a rate equal to 30 percent of the generally applicable rate.

In the case of a wind or biomass facility operated by a lessee, the proposal would permit the lessee, rather than the owner, to claim the credit. This rule would apply to production under leases entered into after the date on which the proposal is enacted.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-124	-264	-355	-209	-90	-92	-1,010	-1,492

PROVIDE TAX CREDIT FOR RESIDENTIAL SOLAR ENERGY SYSTEMS

Current Law

A 10-percent investment tax credit is provided to businesses for qualifying equipment that uses solar energy to generate electricity, to heat or cool or provide hot water for use in a structure, or to provide solar process heat. No credit is available for nonbusiness purchases of solar energy equipment.

Reasons for Change

A tax credit for solar energy equipment used to generate electricity (photovoltaic equipment) or heat water (solar water heating equipment) will reduce the cost of these investments and encourage individuals to adopt these systems. Solar energy will be an important part of the Nation's long-term energy supply. Increasing the demand for these systems should also increase private-sector research to reduce costs further and increase efficiency.

Proposal

Individuals that purchase photovoltaic equipment or solar water heating equipment for use in a dwelling unit that the individual uses as a residence would be allowed a nonrefundable personal credit equal to 15 percent of the cost of the equipment and its installation. Equipment would qualify for the credit only if it is used exclusively for purposes other than heating swimming pools. The Secretary of the Treasury would be authorized to prescribe regulations providing for recapture of the credit if the equipment is used in a manner inconsistent with this requirement. An individual would be allowed a cumulative maximum credit of $2,000 per residence for photovoltaic equipment and $2,000 per residence for solar water heating equipment.

The credit would apply only to solar water heating equipment placed in service after December 31, 2002, and before January 1, 2006, and to photovoltaic systems placed in service after December 31, 2002, and before January 1, 2008.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-4	-7	-10	-18	-25	-11	-71	-71

MODIFY TREATMENT OF NUCLEAR DECOMMISSIONING FUNDS

Current Law

Although accrual basis taxpayers generally may not deduct an item until economic performance occurs, a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund.

A qualified nuclear decommissioning fund is a segregated fund that is established by the taxpayer, restricted to certain types of investments, and used exclusively for the payment of decommissioning costs, taxes on fund income, and management costs. Contributions to the fund are deductible in the year made to the extent they were collected as part of the cost of service to ratepayers. Withdrawals from the fund to pay for decommissioning expenses are included in income at the time of withdrawal, but the taxpayer also is entitled to a deduction for decommissioning expenses as economic performance for those costs occurs. A 20-percent tax rate applies to the taxable income of the fund.

Nuclear decommissioning costs are otherwise deductible (without regard to section 280B) expenses to be incurred in connection with the entombment, decontamination, dismantlement, removal, and disposal of a nuclear plant that has permanently ceased the production of electricity.

Accumulations in a qualified fund are limited to the amount necessary to pay post-1983 nuclear decommissioning costs (determined as if decommissioning costs accrued ratably over the estimated useful life of the plant). To prevent accumulations of funds in excess of those required to pay post-1983 decommissioning costs and to ensure that contributions to the fund are not deducted more rapidly than level funding, taxpayers are required to obtain a ruling from the IRS to establish the maximum annual contribution that may be made to the fund. Taxpayers are required to obtain subsequent rulings setting new ruling amounts in certain instances.

A qualified fund may be transferred in connection with the sale, exchange, or other transfer of the nuclear power plant to which it relates. If the transferee is eligible to maintain a qualified fund and continues to maintain the fund after the transfer while satisfying certain other conditions, the regulations treat the transfer as a nontaxable transaction. No gain or loss is recognized on the transfer of the qualified decommissioning fund and the transferee takes the transferor's basis in the fund. The regulations also permit the IRS to treat a transfer that does not satisfy these conditions as a nontaxable transaction (with continued qualification of the fund) when that is necessary and appropriate to carry out the purposes of the statutory and regulatory provisions relating to qualified funds.

Regulators may also require utilities to set aside amounts for nuclear decommissioning in excess of the amount allowed as a deductible contribution. In addition, pursuant to regulatory requirements, taxpayers may have set aside amounts for nuclear decommissioning prior to the enactment of the qualified fund rules in 1984. The treatment of these pre-1984 amounts varies. Some taxpayers may have received no tax benefit while others may have deducted the amounts or excluded the amounts from gross income.

Reasons for Change

The Administration is concerned that appropriate incentives be provided to insure adequate funds are available for the decommissioning of nuclear power plants. The favorable tax treatment of contributions to nuclear decommissioning funds recognizes the national importance of the establishment of segregated reserve funds for paying nuclear decommissioning costs. Although the favorable tax treatment was adopted at a time when nuclear power plants were operated by regulated public utilities, deregulation will not reduce the need for such funds. Deregulation will, however, generally eliminate traditional cost of service determinations for ratemaking purposes. In many cases, a line charge or other fee will be imposed by a State or local government or a public utility commission to ensure that adequate funds will be available for decommissioning, but there is no assurance that this will be the case under all State deregulation plans.

State deregulation plans frequently require utilities to divest electricity generation assets, including nuclear power plants and related nuclear decommissioning funds. The transferor of a nuclear power plant also may be required to fund the full amount of the plant's decommissioning costs in connection with the transfer. The policy of limiting fund accumulations to the amount necessary to pay post-1983 nuclear decommissioning costs may discourage these transactions and increase the risk that decommissioning costs will not be adequately funded.

Deregulation has also made it increasingly common for nuclear decommissioning funds to be transferred in transactions that do not satisfy the generally applicable regulatory conditions for nontaxability. Uncertainty concerning the tax treatment of these transfers may be impeding the transition to deregulated electricity markets.

Proposal

The cost of service limitation would be eliminated. Thus, unregulated taxpayers would be allowed a deduction for amounts contributed to a qualified nuclear decommissioning fund.

The maximum contribution and deduction for a taxable year generally would be limited to the ruling amount obtained from the IRS, but taxpayers would be permitted to make contributions in excess of the ruling amount in two cases. First, taxpayers would be permitted to make transfers to a qualified fund of amounts held in certain nonqualified nuclear decommissioning funds to the extent such amounts do not exceed the present value of the amount required to pay the plant's pre-1984 decommissioning costs. Transfers would be permitted from a fund in which amounts are irrevocably set aside pursuant to the requirements of a State or Federal agency exclusively for the purpose of funding the decommissioning of the nuclear power plant. Second, if the present value of the amount required to pay the plant's pre-1984 decommissioning costs exceeds the amount held in such nonqualified funds, the taxpayer would be permitted to contribute an amount equal to the excess. Any portion of the amount transferred under these rules that exceeds the amount previously deducted (other than under the qualified fund rules) or excluded from the taxpayer's gross income on account of the taxpayer's liability for decommissioning costs would be allowed as a deduction ratably over the remaining useful life of the nuclear power plant. If the qualified fund is subsequently transferred, deductions under this rule for periods subsequent to the transfer will be allowed to the transferee rather than the transferor unless the transferor is tax exempt. Accumulations in the fund attributable to amounts contributed under these rules would not be taken into account in determining the ruling amount for the fund.

The treatment of transfers of qualified funds would be clarified. Any transfer of a qualified fund in connection with the transfer of the power plant with respect to which the fund was established would be nontaxable and no gain or loss will be recognized by the transferor or transferee as a result of the transfer.

The proposal would also permit taxpayers to make deductible contributions to a qualified fund after the end of the nuclear power plant's estimated useful life and would provide that nuclear decommissioning costs are deductible when paid.

The proposal would be effective for taxable years beginning after December 31, 2002.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-14	-251	-180	-191	-201	-212	-1,035	-2,260

PROVIDE TAX CREDIT FOR PURCHASE OF CERTAIN HYBRID AND FUEL CELL VEHICLES

Current Law

No generally available income tax credit for purchases of hybrid vehicles is available currently. A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electric current, the original use of which commences with the taxpayer, and that is acquired for use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2004. The credit begins to phase down in 2004 and does not apply to vehicles placed in service after 2006.

Certain costs of qualified clean-fuel property, including clean-fuel vehicles, may be deducted when such property is placed in service. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction for clean-fuel vehicles begins to phase down in 2004 and does not apply to property placed in service after 2006.

Reasons for Change

The transportation sector now accounts for 69 percent of U.S. oil consumption. Cars, sport utility vehicles, light trucks, and minivans alone account for 40 percent of U.S. oil consumption, about 20 to 40 percent of all urban smog-forming emissions, and 20 percent of greenhouse gas emissions. Almost all of these vehicles use a single gasoline-fueled engine.

Hybrid vehicles, which have more than one source of power on board the vehicle, and electric vehicles have the potential to reduce petroleum consumption, air pollution, and greenhouse gas emissions. The proposed credits will encourage the purchase of highly fuel-efficient vehicles that incorporate advanced automotive technologies and will help to move hybrid and fuel cell vehicles from the laboratory to the highway. These vehicles can significantly reduce oil consumption, emissions of air pollutants, and emissions of carbon dioxide, the most prevalent greenhouse gas.

Proposal

The proposal would provide temporary tax credits for certain hybrid and fuel cell vehicles:

(1) Credit for qualified hybrid vehicles. A credit, of up to $4,000, would be available for purchases of qualified hybrid vehicles after December 31, 2002, and before January 1, 2008. The credit would be:

(a) $250 if the rechargeable energy storage system provides at least 5 percent but less than 10 percent of the maximum available power;
(b) $500 if the rechargeable energy storage system provides at least 10 percent and less than 20 percent of the maximum available power;

(c) $750 if the rechargeable energy storage system provides at least 20 percent and less than 30 percent of the maximum available power; and
(d) $1,000 if the rechargeable energy storage system provides 30 percent or more of the maximum available power.

If the vehicle's fuel economy exceeds the 2000 model year city fuel economy, the amount of credit shown in (a) through (d) above would be increased by the following amounts:

(i) $500 if the vehicle achieves at least 125 percent but less than 150 percent of the 2000 model year city fuel economy:
(ii) $1,000 if the vehicle achieves at least 150 percent but less than 175 percent of the 2000 model year city fuel economy;
(iii) $1,500 if the vehicle achieves at least 175 percent but less than 200 percent of the 2000 model year city fuel economy;
(iv) $2,000 if the vehicle achieves at least 200 percent but less than 225 percent of the 2000 model year city fuel economy;
(v) $2,500 if the vehicle achieves at least 225 percent but less than 250 percent of the 2000 model year city fuel economy; and
(vi) $3,000 if the vehicle achieves at least 250 percent of the 2000 model year city fuel economy.

(2) <u>Credit for qualified fuel cell vehicles</u>. A credit of up to $8,000 would be available for the purchase of new qualified fuel cell vehicles after December 31, 2002, and before January 1, 2008. The credit would be $4,000, but, if the vehicle's fuel economy exceeds the 2000 model year city fuel economy, the credit would increase by the following amounts:

(i) $1,000 if the vehicle achieves at least 150 percent but less than 175 percent of the 2000 model year city fuel economy;
(ii) $1,500 if the vehicle achieves at least 175 percent but less than 200 percent of the 2000 model year city fuel economy;
(iii) $2,000 if the vehicle achieves at least 200 percent but less than 225 percent of the 2000 model year city fuel economy;
(iv) $2,500 if the vehicle achieves at least 225 percent but less than 250 percent of the 2000 model year city fuel economy;
(v) $3,000 if the vehicle achieves at least 250 percent but less than 275 percent of the 2000 model year city fuel economy;
(vi) $3,500 if the vehicle achieves at least 275 percent but less than 300 percent of the 2000 model year city fuel economy; and
(vii) $4,000 if the vehicle achieves at least 300 percent of the 2000 model year city fuel economy.

The 2000 model year city fuel economy would be the following:

If the vehicle inertia weight class is:	The 2000 model year city fuel economy is: For a passenger automobile:	For a light truck:
1,500 or 1,750 lbs	43.7 mpg	37.6 mpg
2,000 lbs	38.3 mpg	33.7 mpg
2,250 lbs	34.1 mpg	30.6 mpg
2,500 lbs	30.7 mpg	28.0 mpg
2,750 lbs	27.9 mpg	25.9 mpg
3,000 lbs	25.6 mpg	24.1 mpg
3,500 lbs	22.0 mpg	21.3 mpg
4,000 lbs	19.3 mpg	19.0 mpg
4,500 lbs	17.2 mpg	17.3 mpg
5,000 lbs	15.5 mpg	15.8 mpg
5,500 lbs	14.1 mpg	14.6 mpg
6,000 lbs	12.9 mpg	13.6 mpg
6,500 lbs	11.9 mpg	12.8 mpg
7,000 or 8,500 lbs	11.1 mpg	12.0 mpg

The “vehicle inertia weight class” is defined in regulations prescribed by the Environmental Protection Agency for purposes of title II of the Clean Air Act.

A qualifying hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both: (1) an internal combustion engine or heat engine using combustible fuel, and (2) a rechargeable energy storage system. A qualifying fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. A qualifying vehicle must meet all applicable regulatory requirements.

Maximum available power means the maximum value available from the battery or other energy storage device, during a standard power test, divided by the sum of the battery or other energy storage device and the SAE net power of the heat engine.

These credits would be available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers would be able to claim only one of the credits per vehicle and taxpayers who claim either credit would not be able to claim the qualified electric vehicle credit or the deduction for clean-fuel vehicle property for the same vehicle. Business taxpayers claiming either credit would be subject to the limitations on the general business credit and would be required to reduce the basis of the vehicle by the amount of the credit.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-44	-154	-316	-524	-793	-631	-2,418	-3,202

PROVIDE TAX CREDIT FOR ENERGY PRODUCED FROM LANDFILL GAS

Current Law

Taxpayers that produce gas from biomass (including landfill methane) are eligible for a tax credit ("the section 29 credit") equal to $3 per barrel-of-oil equivalent. For this purpose, a barrel-of-oil equivalent is the amount of gas that has a Btu (British thermal unit) content of 5.8 million. To qualify for the credit, the gas must be produced domestically from a facility placed in service by the taxpayer before July 1, 1998, pursuant to a written binding contract in effect before January 1, 1997. In addition, the gas must be sold to an unrelated person before January 1, 2008.

The amount of the section 29 credit generally is adjusted by an inflation adjustment factor for the calendar year in which the sale occurs. The inflation adjustment factor for the 2001 calendar year was 2.0917, and the inflation-adjusted amount of the credit for that year was $6.28 per barrel or barrel equivalent. The credit begins to phase out if the annual average unregulated wellhead price per barrel of domestic crude oil exceeds $23.50 multiplied by the inflation adjustment factor. For 2001, the inflation adjusted threshold for onset of the phaseout was $49.15 ($23.50 x 2.0917) and the average wellhead price for that year was $21.86.

The amount of the section 29 credit allowable with respect to a project is reduced by any unrecaptured business energy tax credit or enhanced oil recovery credit claimed with respect to such project.

The section 29 credit may not be used to offset alternative minimum tax liability. Any unused section 29 credit generally may not be carried back or forward to another taxable year; however, a taxpayer receives a credit for prior year minimum tax liability to the extent that a section 29 credit is disallowed as a result of the operation of the alternative minimum tax. The credit is limited to what would have been the regular tax liability but for the alternative minimum tax.

Reasons for Change

The tax credit helps make fuel produced from landfill methane competitive with other fuels. Extending the credit would continue the important contribution of this renewable energy source to the Nation's long-term energy supply.

Proposal

The credit would be allowed for fuel produced from landfill methane if the fuel is produced from a facility (or portion of a facility) placed in service after December 31, 2002, and before January 1, 2011, and is sold (or used to produce electricity that is sold) before January 1, 2011. The credit for fuel produced at landfills subject to EPA's 1996 New Source Performance Standards/Emissions Guidelines would be limited to two-thirds of the otherwise applicable amount beginning on January 1, 2008, if any portion of the facility for producing fuel at the landfill was placed in service before July 1, 1998, and beginning on January 1, 2003, in all other cases. The proposal would clarify, for purposes of determining the extent to which a facility is placed in service after December 31, 2002, that the facility includes the wells, pipes, and related components used to collect landfill methane and that only production attributable to wells, pipes, and related components placed in service after December 31, 2002, is treated as produced from the portion of the facility placed in service after that date.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-5	-28	-65	-88	-99	-112	-392	-707

PROVIDE TAX CREDIT FOR COMBINED HEAT AND POWER PROPERTY

Current Law

Combined heat and power (CHP) systems are used to produce electricity (and/or mechanical power) and usable thermal energy from a single primary energy source. No income tax credit is currently provided for investments in CHP property.

Depreciation allowances for CHP property vary by asset use and capacity. Assets used to produce electricity with a capacity of 500 kilowatts or less are classified with other manufacturing assets, and generally have cost recovery periods of five to ten years. Other assets employed in the production of electricity have either a 15-year or 20-year recovery period. For assets that are structural components of buildings, however, the recovery period is either 39 years (if nonresidential real property) or 27.5 years (if residential rental property).

Reasons for Change

Combined heat and power systems utilize thermal energy that is otherwise wasted when producing electricity by more conventional methods. CHP systems achieve a greater level of overall energy efficiency, and thereby lessen the consumption of primary fossil fuels. They can lower total energy costs and reduce carbon emissions. An investment tax credit for CHP assets is expected to encourage increased energy efficiency by accelerating planned investment and inducing additional investment in CHP systems. The increased demand for such equipment should, in turn, reduce CHP production costs and spur additional technological innovations in improved CHP systems.

Proposal

The proposal would establish a 10-percent investment credit for qualified CHP systems with an electrical capacity in excess of 50 kilowatts or with a capacity to produce mechanical power in excess of 67 horsepower (or an equivalent combination of electrical and mechanical energy capacities). CHP property would be defined as property comprising a system that uses the same energy source for the simultaneous or sequential generation of (1) electricity or mechanical shaft power (or both) and (2) steam or other forms of useful thermal energy (including heating and cooling applications). A qualified CHP system would be required to produce at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof) and would also be required to satisfy an energy-efficiency standard. For CHP systems with an electrical capacity in excess of 50 megawatts (or a mechanical energy capacity in excess of 67,000 horsepower), the total energy efficiency of the system would have to exceed 70 percent. For smaller systems, the total energy efficiency would have to exceed 60 percent. For this purpose, total energy efficiency would be calculated as the sum of the useful electrical, thermal, and mechanical power produced by the system at normal operating rates, measured on a Btu basis, divided by the lower heating value of the primary fuel source for the system supplied. The eligibility of qualified CHP property would be verified under regulations prescribed by the Secretary of the Treasury.

Qualified CHP assets that are assigned cost recovery periods of less than 15 years would be eligible for the credit, but only if the taxpayer elects to treat such property as having a 22-year class life. Thus, for such property, regular tax depreciation allowances would be calculated using a 15-year recovery period and the 150 percent declining balance method.

The credit would be treated as an energy credit under the investment credit component of the section 38 general business credit, and would be subject to the rules and limitations governing that credit. Taxpayers using the credit for CHP equipment would not be entitled to any other tax credit for the same equipment.

The credit would apply to investments in CHP equipment placed in service after December 31, 2002, but before January 1, 2008.

Revenue Estimate[14]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-18	-99	-68	-63	-76	-14	-320	-277

[14] The revenue estimate shown differs from the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004*.

PROVIDE EXCISE TAX EXEMPTION (CREDIT) FOR ETHANOL

Current Law

Current law provides an income tax credit and an excise tax exemption for ethanol and renewable source methanol used as a fuel. In general, the income tax credit for ethanol is 52 cents per gallon, but small ethanol producers (i.e., those producing less than 30 million gallons of ethanol per year) qualify for a credit of 62 cents per gallon on the first 15 million gallons of ethanol produced in a year. A credit of 60 cents per gallon is allowed for renewable source methanol.

As an alternative to the income tax credit, gasohol blenders may claim a gasoline tax exemption of 52 cents for each gallon of ethanol and 60 cents for each gallon of renewable source methanol that is blended into qualifying gasohol.

The income tax credit expires on December 31, 2007, and the excise tax exemption expires on September 30, 2007. In addition, the ethanol credit and exemption are each reduced by 1 cent per gallon in 2005. Neither the credit nor the exemption applies during any period in which motor fuel taxes dedicated to the Highway Trust Fund are limited to 4.3 cents per gallon. Under current law, the motor fuel tax dedicated to the Highway Trust Fund will be limited to 4.3 cents per gallon beginning on October 1, 2005.

Reasons for Change

The tax credit and excise tax exemption help make ethanol and renewable source methanol competitive with other fuels. Extending the credit and exemption would continue the important contribution of these renewable energy sources to the Nation's long-term energy supply.

Proposal

The income tax credit and the excise tax exemption would be extended through December 31, 2010. The current law rule providing that neither the credit nor the exemption applies during any period in which motor fuel taxes dedicated to the Highway Trust Fund are limited to 4.3 cents per gallon would be retained. As under current law, the credit and the exemption would each be reduced by 1 cent per gallon in 2005.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
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TAX ADMINISTRATION AND UNEMPLOYMENT INSURANCE

Improve Tax Administration

MODIFY THE IRS RESTRUCTURING AND REFORM ACT OF 1998 (RRA98)

Make Section 1203 of the IRS Restructuring and Reform Act of 1998 more effective and fair

Current Law

Section 1203 of the IRS Restructuring and Reform Act of 1998 (RRA98) requires the Commissioner of Internal Revenue to terminate an employee for certain specifically enumerated violations committed by the employee in connection with the performance of the employee's official duties. The Commissioner has non-delegable authority to determine whether mitigating factors support a personnel action other than termination for a covered violation.

Reasons for Change

The Administration's proposal would enhance the IRS' effectiveness by more carefully tailoring the types of conduct by IRS employees that are subject to sanctions, by reinforcing the seriousness with which covered violations will be handled, by providing clear guidance to IRS employees regarding covered conduct and associated penalties, and by allowing the imposition of penalties that are commensurate with specific violations.

Current law requires the termination of an IRS employee for the failure to timely file tax returns, except when such failure is due to reasonable cause and not due to willful neglect. An IRS employee who fails to timely file a refund return (i.e., for a year for which the employee is entitled to a refund) is subject to termination even though a taxpayer who files a refund return late generally is not subject to any penalty. Late-filed refund return cases have constituted a significant percentage of the section 1203 cases to date, and these cases do not represent the type of serious conduct for which the penalties imposed by the statute should apply. In addition, a number of section 1203 cases have involved allegations of wrongful conduct by IRS employees against other IRS employees. The Treasury Inspector General for Tax Administration has recommended that these types of cases be removed from the list of violations covered by section 1203 of RRA98. Such allegations can be addressed by existing administrative and statutory procedures. The Administration's proposal would eliminate late refund returns and employee vs. employee acts from the list of covered violations. The proposal also would strengthen taxpayer protections by enhancing the Commissioner's ability to punish the unauthorized access of taxpayer return information.

Current law requires termination for any covered violation unless the Commissioner personally determines that mitigating factors justify some other personnel action. The proposal would require the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of covered violations. These guidelines will provide notice to IRS employees of the punishment that would result from specific violations. This change would improve IRS employee morale and enhance the fundamental fairness of the statute.

Proposal

The Administration's proposal would modify section 1203 of RRA1998 by (i) removing the late-filing of refund returns from the list of violations; (ii) removing employee vs. employee acts (i.e., for violation of an employee's, rather than a taxpayer's, Constitutional or civil rights) from the list of violations; and (iii) adding the unauthorized inspection of returns or return information to the list of violations. In addition, the proposal would require the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by section 1203 of RRA 98. The Commissioner would retain the non-delegable authority to determine whether mitigating factors support a personnel action other than that specified in the guidelines for a covered violation.

The proposal would be effective upon enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
--	--	--	--	--	--	--	--

Curb the use of frivolous submissions and filings made to impede or delay tax administration

Current Law

The IRS may assert a penalty of $500 on an individual who files a return that either does not contain sufficient information to allow the IRS to determine whether the tax shown on the return is correct or contains information indicating that the tax shown is substantially incorrect, if the return was filed based on a position that is frivolous or, based on information on the return, was intended to delay or impede tax administration.

Reasons for Change

The IRS has been faced with a significant number of tax filers who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. In addition, taxpayers are using existing procedures for Collection Due Process hearings, offers in compromise, and installment agreements to impede or delay tax administration by raising frivolous arguments. The IRS generally must address such frivolous arguments through mandated procedures, which results in delay and additional administrative burden and expense. Allowing the IRS to assert more substantial penalties for frivolous submissions, and to dismiss frivolous requests without the need to follow otherwise mandated procedures, would deter egregious taxpayer behavior and enable the IRS to utilize its resources more efficiently.

Proposal

The Administration's proposal would increase the penalty for frivolous tax returns from $500 to $5,000. In addition, the proposal would permit the IRS to dismiss requests for Collection Due Process hearings, installment agreements, and offers in compromise if they are based on frivolous arguments or are intended to delay or impede tax administration. Individuals submitting such requests would be subject to a $5,000 penalty for repeat behavior or failure to withdraw the request after being given the opportunity to do so. The IRS would be permitted to maintain administrative records of frivolous submissions by taxpayers. The IRS, however, would be required to remove the designation of a taxpayer if, after a reasonable period of time, no further frivolous submissions are made by the taxpayer. Finally, the proposal would require the IRS to publish, at least annually, a listing of positions, arguments, requests, and proposals deemed frivolous for purposes of non-return submissions covered by the provision.

The proposal would be effective for submissions made on or after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
--	--	--	--	--	--	--	--

Authorize partial-liability installment agreements

Current Law

The IRS may enter into an agreement to allow the taxpayer to pay a tax liability in installments. The IRS, however, generally may enter into an installment agreement only if the agreement provides for the full payment of the liability.

Reasons for Change

The Administration's proposal would provide the IRS with an additional option for entering into agreements with taxpayers for the voluntary repayment of delinquent tax liabilities. Currently, the IRS may enter into an installment agreement for full payment of the taxes or may accept an offer in compromise resulting in final settlement of the account for less than full payment. For taxpayers unable to pay in full through an installment agreement, an offer in compromise may not be a practical alternative. For example, a taxpayer may have limited assets, such as a modest amount of equity in a home or business, but the taxpayer cannot make payments equal to the amount of that equity. At the same time, the equity may not be sufficient to justify the costs of enforced collection, and seizure of the asset may leave the taxpayer with an even lesser ability to make future payments.

For a taxpayer who is unable to pay in full through monthly payments and unable to propose an acceptable compromise, but who desires to make some payment, a partial-liability installment agreement would allow the taxpayer to make payments towards the taxpayer's liability and also would permit the IRS to collect a larger amount, including the entire liability, if the taxpayer's circumstances change. Moreover, such an agreement would protect the taxpayer from other IRS collection action while the agreement was in effect (i.e., the taxpayer continues to comply with the payment obligations, and the taxpayer's financial circumstances have not improved to a degree allowing the collection of a greater amount).

Proposal

The Administration's proposal would allow the IRS to enter into installment agreements for amounts less than the full liability owed by taxpayers.

The proposal would be effective for agreements entered into on or after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	78	54	56	57	59	304	624

Allow for the termination of installment agreements for failure to file returns and for failure to make tax deposits

Current Law

The IRS may terminate an agreement with a taxpayer to pay a tax liability in installments only for specific statutory grounds. These statutory grounds do not include a taxpayer's failure to file required returns or a taxpayer's failure to make required tax deposits.

Reasons for Change

The IRS administrative procedures require that installment agreements contain a provision requiring taxpayers to meet all return filing and deposit obligations during the term of the agreement. This provision is intended to insure that the privilege of paying a tax liability in installments is extended only to those taxpayers willing to commit to future compliance. The installment agreement statute, however, does not allow the IRS to terminate an agreement even if a taxpayer fails to file required returns or fails to make required federal tax deposits, and the taxpayer may incur significant additional unpaid tax liability before the IRS can terminate the agreement.

Proposal

The Administration's proposal would permit the IRS to terminate an installment agreement if a taxpayer fails to timely file tax returns or if a taxpayer fails to timely make required federal tax deposits.

The proposal would be effective for failures occurring on or after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
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Consolidate judicial review of collection due process cases in the United States Tax Court

Current Law

The Collection Due Process (CDP) statutes entitle taxpayers to notice and a right to a CDP hearing with the IRS Office of Appeals after the filing of a notice of Federal tax lien and prior to an intended levy. The taxpayer may request judicial review of a determination by the IRS Office of Appeals. The CDP statutes currently provide that venue for the review of an Appeals determination in a CDP case depends on which court (i.e., Tax Court or district court) would have jurisdiction over the underlying tax. Under this rule, the Tax Court reviews CDP cases involving deficiency-type taxes, generally income and estate taxes. The district court reviews cases involving nondeficiency-type taxes, generally employment and excise taxes.

Reasons for Change

The current statute, which divides responsibility for judicial review between the Tax Court and district courts, was intended to give jurisdiction to the court that would have the most expertise over the underlying tax. In practice, however, taxpayer challenges in CDP cases have focused primarily on collection issues rather than liability issues. In particular, relatively few district court cases have involved challenges to the underlying tax liability.

The division of jurisdiction between the Tax Court and the district courts has needlessly complicated the CDP process by making it more confusing and expensive for taxpayers. A taxpayer who mistakenly files a request for review with the wrong court must incur the expense of refiling the case. In certain circumstances, a taxpayer may be required to seek judicial review in both the Tax Court and a district court. In addition, there are indications that some taxpayers are using the venue provisions to delay collection activity by deliberately filing the case with the wrong court.

Most cases seeking judicial review of Appeals determinations in CDP cases already are handled by the Tax Court. This proposal not only will simplify and streamline the CDP process for taxpayers but will also enable the Government and taxpayers to benefit from the Tax Court's expertise in CDP issues.

Proposal

The Administration's proposal would provide that the United States Tax Court shall be the exclusive venue for suits to obtain judicial review of any determination issued by Appeals after a CDP hearing.

The proposal would be effective for suits to obtain judicial review filed on or after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
--	--	--	--	--	--	--	--

Eliminate the monetary threshold for counsel review of offers in compromise

Current Law

Whenever a compromise is reached between the IRS and a taxpayer under section 7122, a record of the compromise must be placed on file along with an opinion from the IRS Chief Counsel. The opinion of Chief Counsel is not required when the total liability, including penalties and interest, is less than $50,000. All compromises, regardless of amount, are subject to continuous quality review by the Secretary.

Reasons for Change

The Administration's proposal would allow the IRS to more efficiently direct resources for offer in compromise (or OIC) cases while retaining existing quality review procedures. Many OIC cases do not present any significant legal issues, and the required legal review for cases meeting the statutory threshold can delay the acceptance process under current administrative procedures. The proposal would require the establishment of criteria for determining when review by Chief Counsel is appropriate. By retaining the requirement of continuous quality review by the Secretary, this proposal would insure that the overall quality of case dispositions does not decline.

Proposal

The Administration's proposal would eliminate the requirement that the opinion of Chief Counsel be placed on file for any accepted offer in compromise involving unpaid tax, penalty, and interest equal to or exceeding $50,000. This proposal would require the Secretary to establish standards for determining when an opinion of Counsel must be obtained.

The proposal would be effective for offers in compromise submitted or pending on or after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
--	--	--	--	--	--	--	--

INITIATE IRS COST SAVING MEASURES

Allow the Financial Management Service to retain transaction fees from levied amounts

Current Law

The IRS may continuously levy 15 percent of a delinquent taxpayer's federal payments under the Federal Payment Levy Program (FPLP). The FPLP is administered by the Financial Management Service (FMS) of the Department of the Treasury. By statute, FMS must charge the IRS the costs incurred by FMS in developing and operating the FPLP. For the current fiscal year, the IRS expects that the FPLP fees charged by FMS will be between $8 and $9 million.

Reasons for Change

The IRS pays the FPLP fees to FMS out of the IRS' own appropriations. The FPLP fees have increased since the inception of the program due to increased FMS costs and increased use of the FPLP program. The proposal would alter internal government accounting to effectively eliminate accounting costs.

Proposal

The Administration's proposal would allow FMS to retain directly a portion of the levied funds as payment for FMS's fees. A delinquent taxpayer, however, would receive full credit for the amount levied upon – i.e., the amount credited to a taxpayer's account would not be reduced by FMS's fee.

The proposal would be effective upon enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
--	--	--	--	--	--	--	--

Extend the due date for electronically filed returns

Current Law

Individual taxpayers must file their income tax returns, and pay any tax balance due, on or before April 15 following the close of the calendar year. (A taxpayer may request an extension of time to file a return, but no extension is available for the making of tax payments.) A variety of filing methods may be used by taxpayers, including electronic filing, mailing with the U.S. Postal Service, and delivery by certain private carriers. A taxpayer's failure to timely file a return or timely pay a tax liability is subject to penalties and/or interest.

Reasons for Change

In the IRS Restructuring and Reform Act of 1998 (RRA98), Congress established a goal of having at least 80 percent of all Federal tax and information returns filed electronically by 2007. Although the number of taxpayers filing returns electronically has increased each year, the current rate of growth is not sufficient to meet this goal. In addition, most taxpayers filing returns electronically are taxpayers who are claiming refunds, as opposed to taxpayers having balances due. The proposal would provide an incentive to file electronically, particularly for taxpayers who have a balance due and refund filers who file later in the filing season. By extending the due date for electronic returns, this proposal also would extend the due date for any tax balance due as that due date is keyed to the return due date. The extended due date for tax payments, however, would apply only if the payments are made by electronic funds transfer. This proposal would encourage additional taxpayers to file returns electronically. Increased use of electronic filing and electronic payment will reduce processing costs for the federal government.

Proposal

The Administration's proposal would extend the return filing and payment date for the filing of individual income tax returns from April 15 to April 30, if the return is filed electronically. In order to qualify for this extended return due date, any balance due must be paid electronically by the extended return due date. The due date for returns filed on paper would remain April 15.

The proposal would be effective for taxable years beginning after December 31, 2002.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
--	--	--	--	--	--	--	--

REPEAL SECTION 132 OF THE REVENUE ACT OF 1978 AND AMEND THE TAX CODE TO AUTHORIZE THE SECRETARY OF THE TREASURY TO ISSUE RULES TO ADDRESS INAPPROPRIATE NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

Current Law

Amounts received by an individual as compensation for services are income under section 61, and property received in connection with the performance of services is income under section 83. Under the rules of section 451, an individual has income in the year in which the compensation is actually or constructively received. An individual is in constructive receipt of income unless there is a substantial limitation on the individual's ability to receive the income currently. The amount and timing of income attributable to amounts payable under a funded employee trust are determined under section 402(b).

Nonqualified deferred compensation plans are unfunded arrangements under which an employer promises to pay compensation in the future. An individual will have current income with respect to amounts payable under such an arrangement unless the ability to receive payments is subject to a substantial limitation, the arrangement is unfunded, and the individual's right to receive future payment is not assignable or otherwise transferable. In order for a plan to be considered unfunded, any assets held in connection with the arrangement must remain the property of the employer and must be within the reach of the employer's creditors if the employer becomes insolvent. If the assets cannot be reached by the employer's creditors, the arrangement is considered funded and the individual is subject to immediate taxation.

Under section 404(a)(5), the employer's deduction for nonqualified deferred compensation is deferred until the individual includes the amount in income.

In 1978, the Department of the Treasury and the Internal Revenue Service (IRS) issued Proposed Treasury Regulations section 1.61-16, providing for current inclusion of compensation deferred "at the taxpayer's individual option." Section 132 of the Revenue Act of 1978, which was enacted to prevent finalization of section 1.61-16, provides that the taxable year of inclusion of any amount under a private deferred compensation plan "shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978." The broad rule-making moratorium imposed by section 132 currently prohibits Treasury and the IRS from issuing new regulations or other guidance on many aspects of nonqualified deferred compensation arrangements (other than, for example, under section 83 or 402(b), to which section 132 does not apply).

Reasons for Change

Section 132 restricts the ability of Treasury and the IRS to respond effectively to arrangements designed to allow individuals to avoid current income for compensation that is, in practice, readily accessible or sheltered from the employer's creditors. These arrangements include ones in which the limitations on an individual's access to the compensation are not substantial as well as arrangements that effectively limit creditor access to assets through restrictions or payout provisions triggered, for example, by financial distress of the employer or through the use of offshore funding vehicles.

Proposal

The Administration's proposal would repeal section 132 of the Revenue Act of 1978 and amend the tax code to authorize the Secretary to issue rules to address inappropriate nonqualified deferred compensation arrangements (i.e., arrangements under which the availability of deferred payments is not actually subject to a substantial limitation, under which assets are in effect placed beyond the reach of the employer's general creditors, or under which the individual otherwise attempts to defer tax on amounts with respect to which he realizes current economic value).

It is expected that new guidance would address when an individual's access to compensation is considered subject to substantial limitation, the extent to which company assets may be designated as available to meet deferred compensation obligations, and when an arrangement is treated as funded. The new guidance would not include finalization of Proposed Treasury Regulation section 1.61-16.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
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PERMIT PRIVATE COLLECTION AGENCIES TO ENGAGE IN SPECIFIC, LIMITED ACTIVITIES TO SUPPORT IRS COLLECTION EFFORTS

Current Law

Federal tax liabilities generally must be collected by the IRS and cannot be referred to a private collection agency, (PCA) for collection.

Reasons for Change

As of July 2002, the IRS designated over $13 billion in delinquent tax liabilities as uncollectible due to IRS collection and resource priorities, and this amount continues to increase. Many of these accounts represent taxpayers who have filed a tax return showing an amount of tax due, but who have failed to pay the tax. Other accounts represent taxpayers who have been assessed additional tax by the IRS and have made three or more voluntary payments to satisfy that additional tax, but who have stopped making payments. These taxpayers are aware of their outstanding liabilities. The IRS, however, is unable to continuously pursue each taxpayer with an outstanding tax liability.

Many taxpayers with outstanding tax liabilities would make payment if contacted by telephone and, if necessary, offered the ability to make payment of the full amount in installments. If PCAs could perform these tasks for this group of taxpayers, without affecting any taxpayer protection, the IRS would be able to focus its resources on more complex cases and issues.

Proposal

Under the proposal, the IRS would be permitted to use PCAs to support IRS collection efforts by having the PCAs locate and contact taxpayers with outstanding tax liabilities. The PCAs would be permitted to request payment of the liability, either in full or in installments, but would not be permitted to take any enforcement action against a taxpayer. The PCAs would be governed by all of the same rules by which the IRS is governed, thus ensuring that taxpayer rights would be safeguarded

Under the proposal, PCAs would first contact each taxpayer by a letter meeting the requirements of the Fair Debt Collection Practices Act (FDCPA) as well as the requirements for comparable notices issued by the IRS. If a taxpayer's last known address is incorrect, and in order to verify the taxpayer's telephone number, PCAs would be permitted to obtain current contact information by using automated database matching (e.g., running a name against an on-line or electronic "white pages") and, if necessary, contacting sources of information such as directory assistance. PCAs, however, would not be permitted to contact individuals (such as relatives and neighbors) or employers to locate a taxpayer.

A PCA would be permitted under the proposal to contact a taxpayer by telephone to request payment of an outstanding tax liability. PCAs would be given specific, limited information regarding an outstanding tax liability (e.g., type of tax, amount of the outstanding liability, tax years affected, and prior payments) to answer basic, but important, questions that a taxpayer may have regarding the liability. If a taxpayer is unable to make full payment, the PCA would be authorized to offer the taxpayer the ability to pay pursuant to an installment agreement providing for full payment of the liability over three years (a "3-year installment agreement"). All 3-year installment agreements would be between the taxpayer and the IRS and would be subject to all of the protections currently provided to taxpayers making payments pursuant to an installment agreement.

If a taxpayer contacted by a PCA requests to pay the outstanding tax liability over more than three years or indicates that the taxpayer is unable to pay the liability in full even over time, the PCA would be permitted under the proposal to obtain from the taxpayer financial information in the same manner that the IRS currently does through its Automated Collection System (ACS). The IRS would be required to provide PCAs with specific training regarding this process, and the information received would be forwarded to the IRS. For special circumstances, such as those involving a deceased or bankrupt taxpayer, the IRS also would be permitted to develop specific procedures for PCAs allowing them to gather information that would enable the IRS to resolve the account administratively. PCAs would not be permitted to subcontract any of their work for the IRS.

Under this proposal, existing taxpayer protections would be fully preserved. PCAs would be subject to careful monitoring by the IRS, including live monitoring of telephonic communications between PCA employees and taxpayers, review of recorded conversations, taxpayer-satisfaction surveys, audits of PCA records, and periodic reviews of PCA performance. In addition, the IRS would be specifically required to monitor PCA compliance with confidentiality requirements and the restrictions contained in section 1203 of RRA98.

Under existing law, the FDCPA would apply to PCAs and would prohibit, for instance, communications with taxpayers at an unusual or inconvenient time or place, and conduct that is harassing, oppressive or abusive. Similarly, PCAs would be subject to existing disclosure restrictions, and the proposal would require annual reports outlining the safeguards in place at the PCAs to protect taxpayer confidentiality and PCA compliance with the confidentiality requirements. The proposal would require PCAs to inform taxpayers of their right to obtain assistance from the Office of the National Taxpayer Advocate and to immediately refer any case in which such assistance is requested to the local Taxpayer Advocate office. PCAs would be prohibited from making contacts with third-parties with respect to a taxpayer's liability absent specific, written authorization from the IRS. All existing Code provisions governing taxpayer notices and taxpayer interviews by IRS employees would apply to PCA contacts with taxpayers. Taxpayers would be permitted under the proposal to pursue claims against a PCA for unauthorized collection actions by the PCA. The Government would have the right to intervene in any action brought by a taxpayer against a PCA, although in no case would the government be liable for a wrongful act of a PCA.

An IRS support unit and a PCA oversight team would work with, monitor, and evaluate each PCA. PCAs would be evaluated based on a number of factors, including quality of service, taxpayer satisfaction, and case resolution, in addition to collection results. The proposal would create a revolving fund from the tax revenue collected under the program, and the amounts in this fund would be used to compensate the PCAs. Taxpayers' accounts would be credited with the gross amounts collected, the same as if the taxes were collected by an IRS employee.

The proposal would be effective after the date of enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	46	128	111	94	97	476	1,008

COMBAT ABUSIVE TAX AVOIDANCE TRANSACTIONS

Current Law

There is no specific penalty for the failure to disclose a transaction required by regulations to be disclosed on a return (a reportable transaction), although such failure may affect a taxpayer's ability to establish a defense to the accuracy-related penalty with respect to any resulting underpayment. Reportable transactions include transactions specifically identified as tax avoidance transactions (listed transactions).

Promoters of certain transactions satisfying a ratio test and certain confidential corporate transactions are required to register these transactions with the IRS. The penalty for failing to timely register these transactions (or for filing false or incomplete information with respect to the registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500. With respect to confidential corporate transactions that must be registered, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees. Promoters also must maintain lists of investors with respect to transactions that must be registered and specified transactions with the potential for the tax avoidance or evasion. The penalty for failing to maintain such lists is $50 for each name omitted (with a maximum penalty of $100,000 per year).

The Code extends the existing common law privilege that applies to communications, with respect to tax advice, between a taxpayer and an attorney to communications between a taxpayer and a federally authorized tax practitioner. This rule is inapplicable to written communications regarding corporate tax shelters.

A person who willfully fails to report a transaction or an account with a foreign financial entity is subject to civil and criminal penalties. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.

A foreign tax credit for foreign taxes paid with respect to dividends from a corporation is not permitted unless the taxpayer meets certain holding period requirements: 15 days (within a 30-day testing period) in the case of common stock and 45 days (within a 90-day testing period) in the case of preferred stock. Periods during which the shareholder is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement.

Existing provisions prohibit taxpayers from using bonds and preferred stock to engage in "income-separation" transactions that are structured to create immediate tax losses or to convert current ordinary income into deferred capital gain. Taxpayers, however, are using other types of assets that provide for relatively stable, periodic income with substantial future value, such as shares in a money-market mutual fund or a lease contract, to engage in similar income-separation transactions.

Reasons for Change

The Treasury Department and the IRS can most effectively address abusive tax avoidance transactions through early identification and analysis of potentially questionable transactions and appropriate enforcement action. Changes to regulations and other forms of published guidance might be required to address an abusive transaction; in other cases, a statutory change may be required.

Current rules provide for the disclosure and registration of certain potentially abusive transactions, and the maintenance of lists of participants in such transactions. The specific rules and definitions applicable to disclosure, registration, and list maintenance, however, are not consistent and the existing penalties (which currently do not apply to the failure to disclose a transaction) are insufficient to effectively reinforce these rules.

Proposal

The proposal would permit Treasury to provide a consistent definition of a transaction that must be disclosed by a taxpayer and registered by a promoter, and for which lists of participants must be maintained by a promoter. The proposal also would strengthen the IRS' enforcement powers with respect to potentially abusive transactions and would modify substantive rules to address areas of identified potential abuse.

A taxpayer failing to disclose a reportable transaction on a return would be subject to a penalty for each failure in the following amounts: (i) for corporate taxpayers with respect to listed transactions, $200,000 and 5% of any underpayment resulting from the listed transaction; (ii) for corporate taxpayers with respect to other reportable transactions, $50,000; (iii) for partnerships, S corporations, and trusts, $200,000 with respect to listed transactions and $50,000 with respect to other reportable transactions; (iv) for individual taxpayers with respect to listed transactions, $100,000 and 5% of any underpayment resulting from the listed transaction; and (v) for individual taxpayers with respect to other reportable transactions, $10,000. Corporate taxpayers would be required to disclose, in their filings with the Securities and Exchange Commission, any penalty for the failure to disclose a listed transaction and any accuracy-related penalty resulting from an undisclosed listed transaction.

The provisions regarding registration with the IRS of certain transactions would be modified to require the registration of any entity, investment plan or arrangement or other plan or arrangement that is of a type determined by the Treasury Department to have the potential for tax avoidance or evasion. The provisions also would be modified to confirm that the requirements and penalties may apply to all organizers and sellers of covered transactions, including persons who assist such persons. With respect to listed transactions, the penalty for the failure to register a transaction would be increased to an amount equal to the greater of 50% of the fees paid to the promoter or $200,000. This penalty would be increased to 75% for the intentional failure to register a transaction or the intentional failure to provide complete or true information as part of a registration. For other reportable transactions, the penalty would be increased to $50,000.

The provisions regarding the maintenance of lists of investors would be modified to confirm that the requirements and penalties may apply to all organizers and sellers of covered transactions, including persons who assist such persons, and that the Treasury Department would not be required to permit one person to maintain a list with respect to a group of persons required to maintain a list. If a promoter fails to provide the IRS with a list of investors within 20 business days after receipt of the IRS' written request, the promoter would be subject to a penalty of $10,000 for each additional business day that the requested information is not provided. This penalty would be imposed for each investor list that a promoter fails to maintain or delays in providing to the IRS. The IRS would have the discretion to extend the deadline or waive all or a portion of the penalty for good cause shown.

The IRS would be given explicit authority to seek an injunction against promoters who disregard the rules requiring the registration of transactions and the maintenance of investor lists.

A penalty of $5,000 would be imposed for non-willful failures to report a transaction or an account with a foreign financial entity. The penalty may be waived if the taxpayer paid all U.S. tax due with respect to the taxpayer's foreign accounts or transactions and the taxpayer demonstrates that the failure to report the transaction or account was due to reasonable cause.

The statutory privilege applicable to taxpayer communications with a federally authorized tax practitioner would not apply to communications with respect to any tax shelter.

The minimum holding period requirement for obtaining a foreign tax credit for foreign taxes paid with respect to dividends would be expanded to disallow any foreign tax credit with respect to any item of income or gain from property if the taxpayer that receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. Regulatory authority would be granted to the Treasury Department to issue regulations providing exceptions in appropriate cases.

An income-separation transaction would be treated as a secured borrowing, not a separation of ownership. Debt characterization would ensure that the parties' ongoing tax treatment of the transaction clearly reflects income.

The proposal generally would be effective after enactment.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
12	45	83	98	99	103	428	1,007

LIMIT RELATED PARTY INTEREST DEDUCTIONS

Current Law

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities. Further, the current-law operation of section 163(j), which provides a safe harbor for corporations with a debt-to-equity ratio of greater than 1.5 to 1, applies inconsistently across taxpayers in different industries and with different leverage pictures. This safe harbor can be better tailored through the use of a debt-to-asset threshold that reflects the underlying mix of assets held by a corporation and the amount of leverage a company with that mix of assets typically can support. Without this tailoring, some businesses could be subject to the tightened limits under section 163(j) even though they may not be considered to be highly leveraged when compared to other businesses operating with a similar mix of assets. Use of a tailored debt-to-asset ratio as a safe harbor, instead of relying on a fixed debt-to-equity ratio across the board, would make an appropriate safe harbor available to the full range of companies, including those in industries and businesses with an asset mix that typically is more highly leveraged. For example, certain businesses can be highly leveraged because their assets are very liquid, such as financial securities. The revised safe harbor based on asset classes would serve to better focus the application of the section 163(j) limits so that the rules, after tightening, would apply only to companies with unusually high levels of indebtedness when compared with other companies that have a similar mix of assets.

Reasons for Change

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities. Further, the current-law operation of section 163(j), which provides a safe harbor for corporations with a debt-to-equity ratio of greater than 1.5 to 1, applies inconsistently across taxpayers in different industries and with different leverage pictures. This safe harbor can be better tailored through the use of a debt-to-asset threshold that reflects the underlying mix of assets held by a corporation and the amount of leverage a company with that mix of assets typically can support. Use of a tailored debt-to-asset ratio as a safe harbor, instead of relying on a fixed debt-to-equity ratio across the board, would make an appropriate safe harbor available to the full range of companies, including those in industries and businesses with an asset mix that typically is more highly leveraged. This would serve to better focus the application of the section 163(j) limits.

Proposal

Section 163(j) would be revised to tighten the limitation on the deductibility of interest to related persons and to tailor more appropriately the applicable safe harbor.

The current law 1.5 to 1 debt-to-equity safe harbor, which applies the same ratio to all corporations without regard to type of business activities conducted by the corporation, would be replaced by an approach that takes into account the types of assets owned by the corporation and the leverage typically associated with various broad classes of assets. Instead of a fixed debt-to-equity ratio, the safe harbor would be determined based on a series of debt-to-asset ratios identified for these asset classes. The revised safe harbor would permit a level of indebtedness (the "safe harbor amount") based on the value of the corporation's assets in each identified class. If the corporation's indebtedness does not exceed the safe harbor amount, the corporation would not be subject to the limits of section 163(j).

Under this approach, a corporation's safe harbor for purposes of section 163(j) would be calculated as follows. The corporation would categorize its assets into the identified classes (as set forth in the table below). The corporation would determine its safe harbor amount by multiplying the value of its assets in each asset class by the respective debt-to-asset ratio for such class, and then totaling such amounts. The corporation would be subject to the limitations of section 163(j) only if its actual indebtedness exceeded this safe harbor amount.

The applicable asset classes and related debt-to-asset ratios are set forth below:

Asset Class	**Debt-to-Asset Ratio**
Cash, Cash Equivalents, Government Securities	.98
Municipal Bonds, Publicly Traded Debt Securities, Receivables	.95
Publicly Traded Equities, Mortgages and Other Real Estate Loans, Other Corporate Debt and 3rd Party Loans	.90
Trade Receivables and Other Current Assets	.85
Inventory	.80
Land, Depreciable Assets, Other Investments, Loans to Shareholders	.70
Intangible Assets	.50

Equity investments in foreign related parties (other than investments in subsidiaries) would not be taken into account for this purpose.

A second limitation would be added to section 163(j) that would deny a deduction for disqualified interest to the extent that the U.S. members of a corporate group are more highly leveraged than the overall worldwide corporate group (the "worldwide limitation"). Under the worldwide limitation, the amount of excess indebtedness in the United States would be determined by comparing the ratio of indebtedness incurred by the U.S. members of the group to assets held by such members with the ratio of indebtedness incurred by all members of the worldwide group to assets held by the worldwide group. Disqualified interest would be disallowed to the extent attributable to such excess U.S. indebtedness. This worldwide limitation would apply separately to the subgroup consisting of all financial corporations in the corporate group. The amount of interest that would be disallowed under the worldwide test would be limited by the revised safe harbor based on asset classes. Specifically, the amount of excess U.S.

indebtedness determined under the worldwide limitation would not exceed the amount by which the corporation's U.S. indebtedness exceeds its safe harbor amount.

The current law provisions of section 163(j) also would be tightened. The threshold for the limitation based on adjusted taxable income would be reduced from 50 percent to 35 percent of adjusted taxable income. The adjusted taxable income limitation and the worldwide limitation would be coordinated by providing that the amount of interest disallowed in a taxable year would be the greater of the amount disallowed under each of the limitations. The indefinite carryforward for disallowed interest under the adjusted taxable income limitation of current law would be limited to five years. A carryforward of interest amounts that exceed the worldwide limitation would not be permitted. The 3-year carryforward of excess limitation would be eliminated.

The proposal would be effective for taxable years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	11	109	198	251	307	876	3,434

REFORM UNEMPLOYMENT INSURANCE ADMINISTRATIVE FINANCING

Current Law

The administrative costs of the unemployment insurance system and a portion of certain extended benefit programs are funded through the Federal Unemployment Tax Act (FUTA). FUTA imposes a net federal payroll tax on employers of 0.8 percent of the first $7,000 paid annually by each employer to each employee, which includes a 0.2 percent surtax scheduled to expire at the end of 2007. (The statutory FUTA rate is 6.2 percent (including the 0.2 percent surtax), but employers who make timely and full payments of their state unemployment insurance taxes are entitled to a credit of 5.4 percent.) The extent to which FUTA balances are distributed to states to cover administrative expenses is determined by the federal appropriations process. The unemployment insurance taxes imposed by each state are held in a federal unemployment trust fund for that state and are used to pay unemployment benefits.

FUTA balances in excess of statutory ceilings are distributed to the states to pay either unemployment benefits or administrative costs of the system (These are known as Reed Act distributions). The Job Creation and Worker Assistance Act of 2002 (JCWAA) eliminated limits on Reed Act distributions enacted in the Balanced Budget Act of 1997.

Reasons for Change

The changes in this proposal are central to the Administration's comprehensive proposal to reform the administrative financing of the unemployment insurance benefits system. Current rules limit the ability of states to use FUTA balances and to structure their programs to best suit each state's needs. Despite the level of FUTA balances, many states do not have the funds they need to administer their programs.

Proposal

Eliminate the 0.2 percent FUTA surtax in 2005 and make additional rate cuts to achieve a net FUTA tax rate of 0.2 percent in 2009. Transfer administrative funding to the states in 2006 and allow the states to use their benefit taxes to pay these costs. Federal administrative grants to states will continue, although at a significantly reduced level. The Administration supports special distributions of $2.7 billion in Reed Act funds on October 1, 2006 and October 1, 2007, to be used for administrative expenses in the transition.

Revenue Estimate[15, 16]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	0	-1,068	-1,440	-3,371	-2,017	-7,896	-13,412

[15] The revenue estimate shown differs from the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004* due to legislation enacted subsequent to the setting of estimates for the Budget.
[16] Estimate is net of income tax offsets.

SIMPLIFY THE TAX LAWS

ESTABLISH UNIFORM DEFINITION OF A QUALIFYING CHILD

Current Law

The tax code provides assistance to families with children through the dependent exemption, head-of-household filing status, child tax credit, child and dependent care tax credit, and earned income tax credit (EITC). However, each of these provisions has a unique definition of eligible child. These are described below.

Dependent Exemption: To qualify as a dependent, an individual must satisfy five tests. First, he or she must either be a qualifying relative or meet certain residency requirements. Qualifying relatives include the taxpayer's (1) son or daughter or a descendant of either (e.g., grandchildren, great-grandchildren); (2) stepson or stepdaughter; (3) sibling or stepsibling; (4) parent or ancestor of a parent (e.g., grandparent, great-grandparent); (5) stepparent; (6) son or daughter of a sibling; (7) parent's sibling; or (8) father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law. If the individual is not a qualifying relative, the taxpayer's home must be his or her principal place of abode for the full tax year, and the individual must be a member of the taxpayer's household.[17]

Second, the individual also must receive more than half of his or her support from the taxpayer.[18] Third, he or she must be a citizen or resident of the United States or a resident of a contiguous country (Canada or Mexico). Fourth, if the individual is married, he or she cannot file a joint tax return with his or her spouse, except to receive a refund of withheld taxes. Fifth, a taxpayer cannot claim a dependent if the dependent's gross income exceeds the exemption amount ($3,050 in 2003). This test does not apply if the dependent is the taxpayer's child (son, daughter, stepson, stepdaughter, or foster child) and is under the age of 19 at the close of the calendar year (under 24 if a full-time student). A foster child is defined to mean an individual for whom the taxpayer "cares for as the taxpayer's own child." A foster child must reside with the taxpayer for the entire year.

Special rules apply to more complicated family situations. For example, in the event of divorce or separation, the custodial parent is generally entitled to the dependent exemption if the parents, in combination, provide over half the support of the child. To qualify as the custodial parent, the taxpayer must reside with his or her child for over half the year. The noncustodial parent may claim the exemption only if the custodial parent provides him or her with a written waiver to be attached to the tax return.

There are other circumstances, in addition to divorce or separation, when more than one taxpayer helps support an individual. If each taxpayer provides less than half of the person's support, but in combination, the taxpayers provide over half of the person's support, then one of the taxpayers can claim the dependent exemption if three additional tests are met. First, the taxpayer meets all

[17] A taxpayer or another individual may still be considered to be a member of the household despite a temporary absence due to special circumstances, such as illness, education, work, military service, or vacation.
[18] Public assistance payments are taken into account as support payments made by a government entity.

the requirements, other than support, for claiming the person as a dependent. Second, the taxpayer contributes over ten percent of the person's support. Third, each of the other taxpayers who provide at least ten percent of the person's support signs a waiver, which the taxpayer claiming the exemption then attaches to his or her tax return.

An exemption is not allowed for any dependent unless a taxpayer identification number for the dependent is included on the taxpayer's tax return.

Head of Household Filing Status: An unmarried taxpayer may be considered a head of household if the taxpayer maintains as his or her home a household that constitutes for more than half of the tax year the principal place of abode for (1) unmarried sons, daughters, stepchildren, or descendants of the taxpayer's sons or daughters; (2) married sons, daughters, stepchildren, or descendants of the taxpayer's sons or daughters, whom the taxpayer can claim as dependents; or (3) relatives whom the taxpayer can claim as dependents (as defined above). An unmarried taxpayer may also claim head of household filing status if he or she maintains a separate household for dependent parents for the tax year.

Child Tax Credit: Taxpayers can claim the child tax credit for qualifying individuals who meet three tests, in addition to the five tests that qualify them as dependents. The qualifying individual must be under the age of 17. Further, the child must be the taxpayer's son, daughter, grandchild, sibling, niece, nephew, or foster child. Stepchildren, stepsiblings, *and* their descendants are also qualifying children. If the child is the taxpayer's sibling, niece or nephew, the taxpayer must care for the child as if the child were his or her own child. Finally, the child must be a citizen or resident of the United States (that is, the contiguous country rule, which applies to the dependent exemption, does not pertain to the child tax credit).

The definition of foster child for the child tax credit differs from that used for dependents. As under the definition of a dependent, a foster child is an individual for whom the taxpayer "cares for as the taxpayer's own child" and who resides with the taxpayer for the entire year. However, the foster child also must be placed with the taxpayer by an authorized placement agency.

Tax Benefits Related to Child Care: A taxpayer may be eligible for the child and dependent care tax credit and the exclusion for employer-provided child care if the taxpayer provides over half the costs of maintaining a home in which the taxpayer and a qualifying individual reside. Qualifying individuals include dependents (as defined above) under the age of 13. Custodial parents may also claim children under the age of 13 whom they would be entitled to claim as dependents if they had not waived the exemption to the noncustodial parents. Qualifying individuals can also include dependents (of any age) or spouses who are physically or mentally incapable of caring for themselves.

To qualify for the credit, a taxpayer must maintain the household in which the taxpayer and the qualifying individual reside. The household maintenance test applies to both married and unmarried filers. A taxpayer must provide over half the cost of maintaining the household for the period during the year in which he or she resides in the home with the qualifying individual.

Earned Income Tax Credit (EITC): A child is a qualifying child if the following three requirements are met: (1) the child must be the taxpayer's son, daughter, grandchild, sibling, niece, nephew, or foster child; (2) the child must generally reside with the taxpayer in the same principle place of abode in the United States for over half the year; and (3) the child must be under the age of 19 (or under 24 if a full-time student). Stepchildren, stepsiblings, *and* their descendants are also qualifying children. If the child is the taxpayer's sibling, niece or nephew, the taxpayer must care for the child as if the child were his or her own child. The definition of foster child is the same as under the child tax credit, except that the residency test is over six months rather than twelve months.

If more than one taxpayer claims the same child for purposes of the EITC, the following rules apply. If each claimant satisfies the age, relationship, and residence tests with respect to the same child, only the taxpayer with the highest adjusted gross income (AGI) can claim the child. However, the parent's claim supercedes the claims of other taxpayers, regardless of the outcome of the AGI tiebreaker test. If both parents file separate returns claiming the child, then the parent who resides with the child the longest is deemed entitled to the EITC. In the event that both parents reside with the child for the same amount of time, then the parent with the highest AGI is entitled to the credit.

Both the taxpayer (and his or her spouse, if married) and qualifying child must have a social security number that is valid for employment in the United States (that is, they must be U.S. citizens, permanent residents, or have certain types of temporary visas that allow them to work in the United States).

Reasons for Change

Taxpayers with children may receive a number of tax benefits to help offset the costs of raising a family. In tax year 2004, there will be nearly 53 million taxpayers with children. Of these, 50 million taxpayers will claim child dependents and tens of millions will claim one or more other child-related tax benefits.

Tax Year 2004

Child-Related Tax Benefit	Number of Returns (millions)
Dependent Exemption	52.9
With Child	49.7
Head of Household Filing Status	24.1
With Child	22.1
Child Tax Credit	30.3
Child and Dependent Care Tax Credit	5.8
Earned Income Tax Credit	20.7
With Child	16.9

In many cases, taxpayers will claim more than one of these benefits. For example, 30.3 million taxpayers will claim both child dependent exemptions and the child tax credit, 16.2 million taxpayers will claim both child dependent exemptions and the EITC, and 10.4 million taxpayers will claim all three. Over a million taxpayers will claim all five of the child-related tax benefits.

But to obtain these benefits, taxpayers must wade through pages of bewildering rules and instructions because each provision defines an eligible "child" differently. For example, to claim the dependent exemption and the child tax credit, a taxpayer must demonstrate that he or she provides most of the support of the child. To claim the EITC, the taxpayer must demonstrate that he or she resides with the child for a specified period of time. Having different definitions for as simple a concept as one's child may confuse taxpayers and lead to erroneous claims of one or more child-related tax benefits. As a recent EITC compliance study found, nearly one in five children claimed as dependents and EITC qualifying children in 1999 were disallowed for one, but not both, tax benefits.

Taxpayer confusion and errors may also be linked to some of the criteria used to determine eligibility for the child-related tax benefits. A 1993 General Accounting Office study found that in 1988, taxpayers erroneously claimed exemptions for an estimated nine million dependents.[19] Nearly three-quarters of erroneous claims were attributable to taxpayers' failure to meet the dependent support test. Among those who did not meet the support test, taxpayers did not provide financial support for 57 percent of the claimed dependents. In the remaining cases, taxpayers lacked adequate records to demonstrate that they had met the support test. Replacing the support test, which is difficult to understand and to administer in the absence of an intrusive audit, with a uniform residency test would reduce both compliance and administrative costs.

Proposal

A uniform definition of qualifying child would be adopted for purposes of determining eligibility for the dependency exemption, the child tax credit, the child and dependent care tax credit, head of household filing status, and the EITC. A qualifying child would have to meet the following three tests:

- Relationship – The child must be the taxpayer's son, daughter, stepchild, sibling, stepsibling, or a descendant of such individuals. Foster children placed with the taxpayer by authorized placement agencies would satisfy the relationship test. If the child is the taxpayer's sibling or stepsibling or a descendant of any such individual, the taxpayer must care for the child as if the child were his or her own child.

- Residence – The child must live with the taxpayer in the same principal place of abode in the United States for over half the year. Military personnel on extended active duty outside the United States would be considered to be residing in the United States. As under current law, the taxpayer and child are considered to live together even if one or both are temporarily absent due to special circumstances such as illness, education, business, vacation, or military service.

- Age – The child must be under the age of 19, a full-time student if over age 18 and under age 24, or totally and permanently disabled. However, as under current law, qualifying children

[19] United States General Accounting Office, *Tax Administration: Erroneous Dependent and Filing Status Claims,* Report GAO/GGD-93-60, March 1993.

(who are not disabled) must be under age 13 for purposes of the child and dependent care tax credit and under 17 (whether or not disabled) to qualify for the child tax credit.

Neither the support nor gross income tests would apply to qualifying children who meet the relationship, residence, and age tests. In addition, taxpayers would no longer be required to meet a household maintenance test when claiming the child and dependent care tax credit.

If more than one taxpayer claims the same qualifying child, then the following tiebreaker rules would apply:

- If only one of the claimants is the child's parent, then he or she would receive the tax benefit.

- If the child's parents do not file a joint return and both claim the child on separate returns, then the tax benefit would accrue to the parent with whom the child resides the longest. If both parents reside with the child for the same length of time, then the benefit would accrue to the parent with the highest AGI.

- If the child's parents do not claim the child, then the tax benefit would accrue to the claimant with the highest AGI.

The proposal repeals the current law provision that allows a custodial parent to release the claim to a dependent exemption to a noncustodial parent if the parents, in combination, provide over half the support of a child. However, if there is a child support instrument between the parents that applies to the dependent and that is in effect as of the date of the announcement of a legislative proposal, then current law would pertain. That is, in such cases, a custodial parent could release the claim to a dependent exemption (and, by extension, the child tax credit) to the noncustodial parent.[20]

Taxpayers could continue to claim individuals who do not meet the proposed relationship, residency, or age tests as dependents if the current law dependency requirements are met.[21] Thus, a taxpayer would still be able to claim a parent as a dependent if the taxpayer provides over half the support of the parent and the parent's gross income is less than the exemption amount. As under current law, taxpayers would also be able to claim a distantly related or unrelated child as a dependent if the child resides in the taxpayer's home for the full year and meets the current law dependency tests. Further, such children would still not qualify the taxpayer for the child tax credit or the EITC unless placed in the home by an authorized placement agency. However, if more than one taxpayer claims a child as a dependent, then the proposed residency-based tests would supercede current law. The current law dependency tests

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[20] Current law specifies that noncustodial parents cannot claim the dependent exemption for a child without receiving a waiver from the child's custodial parent. However, according to the *National Taxpayer Advocate's FY 2001 Annual Report to Congress* (Publication 2104, December 31, 2001) courts in 35 states have held that they have the authority to allocate the dependency exemption between spouses who are before them in a divorce or custody case. Current law may need to be clarified in order to ensure that family courts are correctly interpreting Congressional intent regarding the release of the dependency exemption by the custodial parent.

[21] Under the proposal, a child who provides over half of his or her own support would not be considered a dependent of another taxpayer. This is consistent with current law.

would also continue to apply to children who are U.S. citizens living abroad or non-U.S. citizens living in Canada and Mexico.

Taxpayers would be required to provide a valid taxpayer identification number for each qualifying child. An EITC qualifying child, however, would be required to have a social security number that is valid for employment in the United States (that is, they must be U.S. citizens, permanent residents, or have certain types of temporary visas).

The proposal would be effective for tax years beginning after December 31, 2003.

Revenue Estimate[22]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-26	-23	-24	-28	-19	-120	-194

[22] The revenue estimate shown differs from the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004*.

Comparison of Key Provisions Relating to Qualifying Children

	Dependency Exemption	Head of Household Filing Status	Child Tax Credit	Child and Dependent Care Tax Credit	Earned Income Tax Credit	Proposal
1. Relationship test						
Sons, daughters, grandchildren	Yes	Yes	Yes	Yes	Yes	Yes
	Yes	Yes, if qualifies as a dependent	Yes, if qualifies as a dependent and taxpayer cares for child as his or her own	Same as dependency exemption	Yes, if taxpayer cares for child as his or her own	Yes, if taxpayer cares for child as his or her own
Foster children (which may include relatives and unrelated children)	Any child may be treated as own child if lives with taxpayer for entire year and the taxpayer cares for the child as his or her own	Yes, if qualifies as a dependent	Yes, if lives with taxpayer for entire year, is placed by an authorized placement agency, and taxpayer cares for the child as his or her own	Same as dependency exemption	Yes, if lives with taxpayer for over half the year, is placed by an authorized placement agency, and taxpayer cares for the child as his or her own	Yes, if lives with taxpayer for over half the year and is placed by an authorized placement agency
2. Age limit	Under 19 or under 24 if full-time student	No age limit for unmarried sons, daughters, grandchildren, and stepchildren. Otherwise, same as dependency exemption.	Under 17	Under 13 (no age limit for disabled dependent)	Same as dependency exemption, but no age limit for disabled children	Under 19, under 24 if full-time student, and no age limit for disabled children (however, under 17 for child tax credit and under 13 for child and dependent care tax credit)
3. Gross income limit	Individual cannot be claimed as a dependent if earns more than the exemption amount, except if son, daughter, stepson, stepdaughter, or foster child under age limit	No limit for unmarried sons, daughters, grandchildren, and stepchildren regardless of age; otherwise, same as dependency exemption	Same as dependency exemption	Same as dependency exemption	No limit	No limit
4. Residency requirements	Certain related children do not have to live with the taxpayer, otherwise entire year	Child must live with the taxpayer for over one half of the year	Same as dependency exemption	Child must live with the taxpayer for the period during which the expenses were incurred	Child must live with taxpayer for over one half of the year	Child must live with the taxpayer for over one half of the year
5. Support test	Taxpayer must provide over one half of the child's support.	No support test for unmarried sons, daughters, grandchildren, and stepchildren; otherwise, same as dependency exemption	Same as dependency exemption	Same as dependency exemption	None	None
6. Household maintenance test	None	Taxpayer must provide over one half of the costs of maintaining the household	None	Taxpayer must provide over one half of the costs of maintaining the household for the period during which child lived with taxpayer	None	None, except to claim head of household filing status

SIMPLIFY ADOPTION TAX PROVISIONS

Current Law

Under current law, for taxable years through 2010, two tax benefits are provided to taxpayers who adopt children: (1) a nonrefundable 100 percent tax credit for a limited amount of qualified expenses incurred in the adoption of a child; and (2) an exclusion from gross income of a limited amount of qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. In 2003, the separate limits on qualified adoption expenses for the credit and the exclusion are $10,160. Taxpayers may use both adoption tax benefits, but the same expenses cannot be used for both benefits. Taxpayers who adopt children with special needs may claim the full $10,160 credit or exclusion even if adoption expenses are less than that amount. Taxpayers may carry forward unused credit amounts for up to five years. When modified adjusted gross income exceeds $152,390 (in 2003), both the credit amount and the amount excluded from gross income are reduced pro-rata over the next $40,000 of modified adjusted gross income. The maximum credit and exclusion and the income at which the phase-out range begins are indexed annually for inflation. The limits for the tax credit and the exclusion are per adoption, so that benefits for a given adoption may be claimed over several years.

For taxable years after 2010, taxpayers will be able to claim the adoption credit only if they incur expenses for the adoption of a child with special needs, the qualified expense limit will be $6,000, the credit will be reduced pro-rata between $75,000 and $115,000 of modified adjusted gross income, and the credit amount and beginning of the phase-out range will not be indexed annually for inflation. The exclusion of employer-provided adoption assistance from gross income is not available to taxpayers for taxable years beginning after 2010. However, both the adoption tax credit and the exclusion for employer-provided adoption assistance would remain in effect with all of their current, pre-2011 provisions and limits as a result of the Administration's separate proposal to permanently extend all provisions of EGTRRA.

Reasons for Change

The phase-out provisions of both adoption tax benefits increase complexity for all taxpayers who use the adoption tax benefits, including the vast majority who are not affected by the phase-outs. Moreover, the phase-outs increase marginal tax rates very substantially for taxpayers with incomes in the phase-out range. For example, a family that, in 2003, has $10,160 of adoption expenses eligible for the tax credit and that is in the phase-out range has its marginal tax rate increased by 25.4 percentage points over what its marginal tax rate would otherwise be.

Proposal

The Administration proposes to eliminate the income-related phase-outs of the adoption tax credit and exclusion. The proposal would be effective for taxable years beginning after December 31, 2002.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-4	-36	-37	-39	-40	-42	-194	-429

EXPAND TAX-FREE SAVINGS OPPORTUNITIES

<u>Current Law</u>

Individual Retirement Accounts (IRAs), including traditional, Roth, and nondeductible IRAs, are primarily intended to encourage retirement saving, but can also be used for certain education, medical, and other non-retirement expenses. Each of the three types of IRAs is subject to a different set of rules regulating eligibility and tax treatment.

Under current law, individuals under age 70½ may make contributions to a traditional IRA, subject to certain limits. The contributions are generally deductible; however, the deduction is phased out for workers with incomes above certain levels who are covered by an employer-sponsored retirement plan. For taxpayers covered by employer-plans in 2003, the deduction is phased out for single and head-of-household filers with modified-AGI[23] between $40,000 and $50,000 (increasing in stages to $50,000 to $60,000 in 2005), for married filing jointly filers with modified-AGI between $60,000 and $70,000 (increasing in stages to $80,000 to $100,000 in 2007), and for married filing separately filers with modified-AGI between $0 and $10,000. For a married, filing jointly taxpayer who is not covered, but whose spouse is covered by an employer-sponsored retirement plan, the deduction is phased out with modified-AGI between $150,000 and $160,000. Account earnings are not includible in gross income until distributed. Distributions (including both contributions and account earnings) are includible in gross income.

To the extent a taxpayer cannot or does not make deductible contributions to a traditional IRA, a taxpayer under age 70½ may make nondeductible contributions. In this case, distributions representing a return of basis are not includible in gross income, while distributions representing account earnings are includible in gross income. There is no income limit for nondeductible contributions to a traditional IRA.

Individuals of any age may make contributions to a Roth IRA. Allowable contributions are phased out for workers with incomes above certain levels. Contributions are phased out for single or head-of-household filers with modified-AGI between $95,000 and $110,000, for married filing jointly filers with modified-AGI between $150,000 and $160,000, and for married filing-separate filers with modified-AGI between $0 and $10,000. Account earnings accumulate tax free, and qualified distributions (including account earnings) are not included in gross income for income tax purposes. Nonqualified Roth IRA distributions are included in income (to the extent they exceed basis) and subject to an additional tax. Distributions are deemed to come from basis first.

The annual aggregate limit on contributions to all of a taxpayer's IRAs (traditional, nondeductible, and Roth) is the lesser of compensation or $3,000 for 2003 and 2004 ($3,500 for individuals age 50 and over). The contribution limit is scheduled to increase in stages to $5,000 ($6,000 for individuals age 50 and over) in 2008.

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[23] AGI plus income from education savings bonds, interest paid on education loans, employer-provided adoption assistance benefits, IRA deductions, deductions for qualified higher education expenses, and certain other adjustments.

Taxpayers with AGI of $100,000 or less and who are not married filing separately can convert a traditional IRA to a Roth IRA. In general, the conversion amount is included in gross income (but not for the purposes of the $100,000 limit).

Early distributions from IRAs are generally subject to an additional 10 percent tax. The tax is imposed on the portion of an early distribution that is includible in gross income. It applies in addition to ordinary income taxes on the distribution. The additional tax does not apply to a rollover to an employer plan or IRA, or if the distribution is made in the cases of death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher-education expenses, health-insurance expenses of unemployed individuals, or as part of a series of substantially equal periodic payments.

Minimum distribution rules require that, beginning at age 70½, the entire amount of a traditional IRA be distributed over the expected life of the individual (or the joint lives of the individual and a designated beneficiary). Roth IRAs are not subject to minimum distribution rules during the account owner's lifetime.

Reasons for Change

The three types of IRAs, each subject to different rules regarding eligibility, contributions, tax treatment, and withdrawal, create complexity in the Code. Taxpayers must determine their eligibility for each account and then must decide which plan is best given their circumstances. Furthermore, as their circumstances change over time, taxpayers must continually re-evaluate their eligibility for each plan and determine which plan best meets their needs. Currently, penalty-free withdrawals are allowed for a long list of qualified expenses not related to retirement, and this list has grown over time. The current list of non-retirement exceptions within IRAs weakens the focus on retirement saving, and places a burden on taxpayers to document that withdrawals are used for certain purposes that Congress has deemed qualified. In addition, the restrictions on withdrawals and additional tax on early distributions discourage many taxpayers from making contributions because they are concerned about the inability to access the funds should they need them. Replacing current law IRAs with two new accounts that taxpayers could use over their entire lifetime would simplify the decision-making process while further encouraging savings.

Proposal

The proposal would replace IRAs with Lifetime Savings Accounts (LSAs) that could be used for any type of saving, and a Retirement Savings Accounts (RSAs) that could be used for retirement saving.

Individuals could contribute up to $7,500 per year to their Lifetime Savings Accounts (LSAs), regardless of wage income. No income limits would apply to LSA contributions. Contributions would have to be in cash. Contributions would be nondeductible, but earnings would accumulate tax-free, and all distributions would be excluded from gross income, regardless of the individual's age or use of the distribution. As with current law Roth IRAs, no minimum required distribution rules would apply to LSAs during the account owner's lifetime.

Contribution limits would apply to all accounts held in an individual's name, rather than to contributors. Thus, contributors could make annual contributions of up to $7,500 each to the accounts of other individuals, but the aggregate of all contributions to all accounts held in a given individual's name could not exceed $7,500. Accounts held in a minor's name would become the property of the named individual when the individual attained age 18. Individuals could roll amounts from LSAs over to a member of the individual's family, as defined in section 529(e)(2), subject to the normal gift tax rules. The LSA contribution limit would be indexed for inflation.

Individuals could contribute up to $7,500 per year (or compensation includible in gross income, if less) to their Retirement Savings Account (RSA). As under current law IRA, for an individual who is married filing a joint return, the compensation limitation will only be binding if the combined includible compensation of the spouses is less than $15,000. No income limits would apply to RSA contributions. Contributions would have to be in cash. Contributions would be nondeductible, but earnings would accumulate tax-free, and qualified distributions would be excluded from gross income. The RSA contribution limit would be indexed for inflation.

Qualified distributions from the retirement account would be distributions made after age 58 or in the event of death or disability. Any other distribution would be a nonqualified distribution and, as with current non-qualified distributions from Roth IRAs, would be includible in income (to the extent it exceeds basis) and subject to an additional tax. Distributions would be deemed to come from basis first. As with current law Roth IRAs, no minimum required distribution rules would apply to RSAs during the account owner's lifetime.

Taxpayers would be able to convert balances in Archer Medical Savings Accounts (MSAs), Coverdell Education Savings Accounts (ESAs), and Qualified State Tuition Plans (QSTPs) to LSA balances. Because contributions to ESAs and QSTPs are made after-tax, conversions of these accounts would not be included in income. Because contributions to MSAs are not taxed, conversions of MSAs would be included in income. All conversions must be made before January 1, 2004, and contributions to MSAs, ESAs, and QSTPs made after enactment would not be eligible for conversion.

Existing Roth IRAs would be renamed RSAs and be made subject to the new rules for RSAs. Existing traditional and nondeductible IRAs could be converted into an RSA by taking the conversion amount into gross income, similar to a current-law Roth conversion. However, no income limit would apply to the ability to convert. Taxpayers who convert IRAs to RSAs before January 1, 2004 could include the conversion amount in income ratably over 4 years. Conversions made on or after January 1, 2004 would be included in income in the year of the conversion. Existing traditional or nondeductible IRAs that are not converted to RSAs could not accept any new contributions. New traditional IRAs could be created to accommodate rollovers from employer plans, but they could not accept any new individual contributions. Individuals wishing to roll an amount directly from an employer plan to an RSA could do so by taking the rollover amount (excluding basis) into gross income (i.e., "converting" the rollover, similar to a current law Roth conversion).

Both LSAs and RSAs would become effective in 2003.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($ in millions)							
1,390	10,572	4,803	1,915	-648	-1,822	14,820	2,002

CONSOLIDATE EMPLOYER-BASED SAVINGS ACCOUNTS

Current Law

Qualified Retirement Plans: Under Code section 401, employers may establish for the benefit of employees a retirement plan that may qualify for tax benefits, including a tax deduction to the employer for contributions, a tax deferral to the employee for elective contributions and their earnings, and a tax exemption for the fund established to pay benefits. To qualify for tax benefits, the plan must satisfy multiple requirements. Among the requirements, the plan may not discriminate in favor of highly compensated employees (HCEs) with regard either to coverage or to amount or availability of contributions or benefits. The following cover some, but not all, of the defined-contribution plan rules.

Minimum Coverage Requirement. Qualified plans must satisfy one of the following tests: either the proportion of non-highly compensated employees (NHCEs) covered by the plan is not less than 70 percent of the proportion of highly compensated employees (HCEs) covered by the plan, or the plan covers a proportion of NHCEs found by the Secretary not to be discriminatory and the average benefit percentage of NHCEs is at least 70 percent of the average benefit percentage of HCEs (the "average benefit percentage" test).[24]

Contribution Limits. The total annual contribution to a participant's account may not exceed the lesser of $40,000 or 100 percent of compensation.

General Nondiscrimination Requirement. Qualified plans, both defined-benefit and defined-contribution, must comply with the Section 401(a)(4) prohibition on contributions or benefits that discriminate in favor of HCEs. Detailed regulations spell out the calculations required for satisfying this provision, including optional safe harbors and a general test for nondiscrimination.

Contribution Tests. In addition to the general nondiscrimination requirement, defined-contribution plans that have after-tax contributions or matching contributions are subject to the actual contribution percentage (ACP) test. This test measures the contribution rate to HCEs' accounts relative to the contribution rate to NHCEs' accounts. To satisfy the test, the ACP of HCEs generally cannot exceed the following limits: 200 percent of the NHCEs' ACP if the NHCEs' ACP is 2% or less; two percentage points over the NHCEs' ACP if the NHCEs' ACP is between 2% and 8%; or 125% of the NHCEs' ACP if the NHCEs' ACP is 8% or more.

Three "safe-harbor" designs are deemed to satisfy the ACP test automatically for employer matching contributions (up to 6 percent of compensation) that do not increase with an employee's rate of contributions or elective deferrals. In the first, vested employer matching contributions on behalf of NHCEs are equal to 100 percent of elective deferrals up to 3 percent of compensation, and 50 percent of elective deferrals between 3 and 5 percent of compensation. In the second, vested employer matching contributions follow an alternative matching formula

[24] For the purposes of the latter test, the average benefit percentage is defined as all employer benefits or contributions divided by compensation. Technically, there is a third test, that at least 70 percent of NHCEs must be covered by the plan. However, this general 70 percent test is redundant in the sense that satisfying this test is sufficient (though not necessary) for satisfying the first test listed above.

such that the aggregate amount of matching contributions is no less than it would be under the first design. In the third, vested employer non-elective contributions are at least 3 percent of compensation made on behalf of all eligible NHCEs.

Vesting. In general, employer contributions must vest at least as quickly as under one of the following schedules. Under graded vesting, twenty percent is vested after three years of service and an additional twenty percent vests with each additional year of service, so that the employee is fully vested after seven years of service. Under cliff vesting, the employee has no vested interest until five years of service has been completed, but is then fully vested. However, matching contributions must vest more quickly: under graded vesting, the first twenty percent must vest after two years of service, so that the employee is fully vested after six years of service, and under cliff vesting, the employee becomes fully vested after three years of service.

401(k) plans. Private employers may establish 401(k) plans, which allow participants to choose to take compensation in the form of cash or a contribution to a defined-contribution plan ("elective deferral"). Section 403(b) and 457 plans are similar "cash-or-deferred arrangements" that are not qualified plans and are subject to separate rules (see below). In addition to the rules applying to qualified defined-contribution plans, 401(k) plans are subject to additional requirements.

Annual deferrals under a 401(k) plan may not exceed $12,000 in 2003 (increasing to $15,000 by 2006). Participants aged 50 or over may make additional "catch-up" deferrals of up to $2,000 (increasing to $5,000 by 2006). Elective deferrals are immediately fully vested.

401(k) plans are subject to an actual deferral percentage (ADP) test, which generally measures employees' elective-deferral rates. In applying the ADP test, the same numerical limits are used as under the ACP test. Three 401(k)-plan "safe-harbor" designs (similar to the safe-harbor designs for the ACP test described above) are deemed to satisfy the ADP test automatically.

SIMPLE 401(k) plans. Employers with 100 or fewer employees and no other retirement plan may establish SIMPLE 401(k) plans. Deferrals of SIMPLE participants may not exceed $8,000 in 2003 (increasing to $10,000 by 2005). SIMPLE participants aged 50 or over may make additional "catch-up" deferrals of up to $1,000 (increasing to $2,500 by 2006). All contributions are immediately fully vested. In lieu of the ADP test, SIMPLE plans are subject to special contribution requirements, including a lower annual elective deferral limit and either a matching contribution not exceeding 3 percent of compensation or non-elective contribution of 2 percent of compensation.[25]

Thrift plans. Employers may establish thrift plans under which participants may choose to make after-tax cash contributions. Such after-tax contributions, along with any matching contributions that an employer elects to make, are subject to the ACP test (without the availability of an ACP safe harbor). Employee contributions under a thrift plan are not subject to the $12,000 limit that applies to employee pre-tax deferrals.

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[25] Employer contributions and employee deferrals may be made to SIMPLE IRAs under rules very similar to those applicable to SIMPLE 401(k) plans.

Top Heavy Plans. Additional tests and requirements are applied to plans in which more than 60 percent of the benefits accrue to "key" employees. Key employees are defined as officers with compensation in excess of $130,000, more-than-five-percent owners, and more-than-one-percent owners with compensation in excess of $150,000. The rules include an accelerated vesting schedule and more stringent requirements for minimum benefits and contributions for non-key employees.

Definition of compensation. Current law provides multiple definitions of employee compensation for different qualified plan purposes, such as the limits on contributions and benefits, the limits on deductions for contributions, the determination of highly compensated and key employees, and the application of nondiscrimination and minimum coverage rules.

The definition of "highly compensated employee" is any employee who is a five-percent owner in the current or previous year, or had compensation above a specified value ($90,000 in 2003). However, employers may elect to amend the latter definition by including only employees in the top 20 percent of employees ranked by compensation.

Permitted disparity and cross-testing. Permitted disparity allows for larger contributions or benefits with respect to compensation in excess of the Social Security wage base ($87,000 for 2003). Cross-testing allows defined-contribution plans to satisfy nondiscrimination tests based on projected account balances at retirement age, rather than current contribution rates (thus it allows for larger contributions for older workers).

Roth-treatment of contributions. Effective after December 31, 2005 participants in 401(k) and 403(b) plans can elect Roth treatment for their contributions: That is, contributions would not be excluded from income and distributions would not be included in income. Roth contributions must be accounted for in a separate account. There are no required minimum distributions during an employee's lifetime, but heirs, other than a spouse, are subject to required minimum distributions.

Salary reduction simplified employee pensions (SARSEPs). Employees can elect to have contributions made to a SARSEP or to receive the amount in cash. The amount the employee elects to have contributed to the SARSEP is not currently includible in income and is limited to the dollar limit applicable to employee deferrals in a 401(k) plan. SARSEPs are available only for employers who had 25 or fewer eligible employees at all times during the prior taxable year and are subject to a special nondiscrimination test. The rules permitting SARSEPs were repealed in 1996, but employee deferral contributions can still be made to SARSEPs that were established prior to January 1, 1997.

<u>403(b) plans</u>: Section 501(c)(3) organizations and public schools may establish tax-sheltered annuity plans, also called 403(b) plans. In general these plans are subject to different rules than qualified plans under section 401. Benefits may be provided through the purchase of annuities or contributions to a custodial account invested in mutual funds. Contribution limits (including catch-ups), deferral limits, and minimum distribution rules are generally the same as for 401(k) plans. However, certain employees with 15 years of service may defer additional amounts

according to a complicated three-part formula. Some 403(b) plans are subject to some nondiscrimination rules.

Governmental 457 plans: State and local governments may establish Section 457 plans.[26] In general, these plans are subject to different rules than qualified plans that are defined under section 401. Participant contributions are tax-deferred until substantially vested, and plan earnings are tax-deferred until withdrawal, due to the exemption enjoyed by state and local governments. Participant elective contributions may not exceed the lesser of 100 percent of compensation or $12,000 in 2003 (increasing to $15,000 by 2006). However, participants may make additional contributions of up to twice the standard amount in the last three years before normal retirement age. Participants aged 50 or over may make additional "catch-up" contributions of up to $2,000 (increasing to $5,000 by 2006).

Reasons for Change

The rules covering employer retirement plans are among the lengthiest and most complicated sections of the tax code and associated regulations. The extreme complexity imposes substantial compliance, administrative, and enforcement costs on employers, participants, and the government (and hence, taxpayers in general). Moreover, because employer sponsorship of a retirement plan is voluntary, the complexity discourages many employers from offering a plan at all. This is especially true of the small employers who together employ about two-fifths of American workers. Complexity is often cited as a reason the coverage rate under an employer retirement plan has not grown above about 50 percent overall, and has remained under 25 percent among employees of small firms. Reducing unnecessary complexity in the employer plan area would save significant compliance costs and would encourage additional coverage and retirement saving.

Proposal

The proposal would consolidate those types of defined-contribution accounts that permit employee deferrals or employee after-tax contributions and simplify defined-contribution plan qualification rules.

The proposal would become effective for years beginning after December 31, 2003.

Consolidate 401(k), SIMPLE 401(k), Thrift, 403(b), and Governmental 457 plans, as well as SIMPLE IRAs and SARSEPs, into Employer Retirement Savings Accounts (ERSAs), which would be available to all employers and have simplified qualification requirements.

ERSAs would follow the existing rules for 401(k) plans, subject to the plan qualification simplifications described below. Thus, employees could defer wages of up to $12,000 annually (increasing to $15,000 by 2006), with employees aged 50 and older able to defer an additional $2,000 (increasing to $5,000 by 2006). The maximum total contribution (including employer contributions) to ERSAs would be the lesser of 100 percent of compensation or $40,000. The

[26] Tax-exempt organizations are permitted to establish section 457 plans, but such plans are not funded arrangements and are generally limited to management or highly compensated employees.

taxability of contributions and distributions from an ERSA would be the same as contributions and distributions from the plans that the ERSA would be replacing. Thus, contributions could be pre-tax deferrals or after-tax employee contributions or Roth contributions, depending on the design of the plan. Distributions of Roth and non-Roth after-tax employee contributions and qualified distributions of earnings on Roth contributions would not be included in income. All other distributions would be included in the participants' income.

Existing 401(k) and Thrift plans would be renamed ERSAs and could continue to operate as before, subject to the simplification described below. Existing SIMPLE 401(k) plans, SIMPLE IRAs, SARSEPs, 403(b) plans, and governmental 457 plans could be renamed ERSAs and be subject to ERSA rules, or could continue to be held separately, but if held separately could not accept any new contributions after December 31, 2004.

ERSA Nondiscrimination Testing. The following single test would apply for satisfying the nondiscrimination requirements with respect to contributions for ERSAs: the average contribution percentage of HCEs could not exceed 200% of NHCEs' percentage if the NHCEs' average contribution percentage were 6% or less. In cases in which the NHCEs' average contribution percentage exceeded 6%, the goal of increasing contributions among NHCEs would be deemed satisfied, and no nondiscrimination testing would apply. For this purpose, "contribution percentage" would be calculated for each employee as the sum of all employee and employer contributions divided by the employee's compensation. The ACP and ADP tests would be repealed. Plans sponsored by state and local governments would not be subject to this test. A plan sponsored by a section 501(c)(3) organization would not be subject to this nondiscrimination test (unless the plan permits after-tax or matching contributions) but would be required to permit all employees of the organization to participate.

ERSA Safe Harbor. The design-based safe harbor described below would be sufficient to satisfy the nondiscrimination test for ERSAs described above. The design of the plan must be such that all eligible NHCEs are eligible to receive fully vested employer contributions (including matching or non-elective contributions, but not including employee elective deferrals or after-tax contributions) of at least 3 percent of compensation. To the extent that the employer contributions of 3 percent of compensation for NHCEs are matching contributions rather than non-elective contributions, the match formula must be one of two qualifying formulas. The first formula would be a 50 percent employer match for the elective contributions of the employee up to 6 percent of the employee's compensation. The second would be any alternative formula such that the rate of an employer's matching contribution does not increase as the rate of an employee's elective contributions increase, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions which would be made if matching contributions were made on the basis of the percentages described in the first formula. In addition, the rate of matching contribution with respect to any elective contribution of a HCE at any rate of elective contribution cannot be greater than that with respect to an NHCE.

Roth ERSAs. The effective date for Roth contributions to ERSAs would be after December 31, 2003 (changed from after December 31, 2005, under current law).

Simplify defined-contribution plan qualification requirements.

Defined-contribution plan qualification requirements would be simplified as follows:

Minimum Coverage Requirement. The following single test would apply: plans would be required to cover a percentage of NHCEs that is not less than 70 percent of the share of HCEs that are covered. The existing rules for applying this test would remain, but the general 70 percent test and the average benefit test would be repealed.

Top-heavy rules. The top-heavy rules would be repealed.

Permitted disparity and cross-testing. Permitted disparity and cross-testing would no longer be permitted.

Definitions of compensation and highly compensated employee. The uniform definition of compensation would be all compensation provided to an employee by the employer for purposes of income tax withholding for which the employer is required to furnish the employee a written statement Form W-2, plus elective deferrals. The definition of "highly compensated employee" would be any employee with compensation for the prior year in excess of the Social Security wage base for that year. For 2003, the Social Security wage base is $87,000. The wage base is indexed and increases every year.

Revenue Estimate[27]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-171	-253	-263	-277	-293	-1,257	-3,000

[27] The revenue estimate shown differs from the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004.*

EXPIRING PROVISIONS

Permanently Extend Expiring Provisions

PERMANENTLY EXTEND PROVISIONS EXPIRING IN 2010

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a new 10-percent individual income tax rate bracket, reduced marginal income tax rates for individuals, doubled the child credit and extended its refundability, provided additional incentives for education, eliminated the estate tax, increased IRA and pension incentives, reduced marriage penalties, and provided relief from the alternative minimum tax (AMT). These and a number of other provisions of EGTRRA sunset on December 31, 2010.

Reasons for Change

The tax relief and incentives to work, save, and invest provided by EGTRRA are essential to the long-run performance of the economy. All taxpayers should have the certainty of knowing that the provisions of EGTRRA will extend beyond 2010. Taxpayers make long-term plans far beyond 2010 when saving for their children's education, when undertaking new business ventures, when planning for retirement, and when planning future contributions to charity and bequests for their children. Taxpayers require the certainty that can be provided today by permanently extending the provisions of EGTRRA.

Proposal

The provisions of EGTRRA that sunset on December 31, 2010 would be permanently extended.

Revenue Estimate[28]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
44	-303	-829	-1,346	-1,573	-1,778	-5,829	-522,967

[28] The estimate includes both receipt and outlay effects. There is no outlay effect in the fiscal years 2004 through 2008. The outlay effect for the proposal is $24,525 in the fiscal years 2004 through 2013.

PERMANENTLY EXTEND THE RESEARCH AND EXPERIMENTATION (R&E) TAX CREDIT

Current Law

The research and experimentation (R&E) tax credit is 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The taxpayer's fixed base percentage generally is the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year. Taxpayers can elect into a three-tiered alternative credit that has lower credit rates (ranging from 2.65 to 3.75 percent) and lower statutory fixed base percentages (ranging from 1 to 2 percent). The R&E credit is scheduled to expire on June 30, 2004.

Reasons for Change

The R&E credit encourages technological developments that are an important component of economic growth. However, uncertainty about the future availability of the R&E credit diminishes the incentive effect of the credit because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. To improve the credit's effectiveness, the R&E credit should be made permanent.

Proposal

The proposal would make the R&E credit permanent.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-1,005	-3,278	-5,187	-6,291	-7,129	-22,890	-67,922

REPEAL THE DISALLOWANCE OF CERTAIN DEDUCTIONS OF MUTUAL LIFE INSURANCE COMPANIES

Current Law

Life insurance companies may generally deduct policyholder dividends, while dividends to stockholders are not deductible. Section 809 of the Internal Revenue Code, enacted in 1984, was intended to address a long-standing question regarding whether a portion of the policyholder dividends paid by a mutual life insurance company should be more appropriately characterized as a payment of non-deductible stockholder dividends. Section 809 identifies such an amount, and reduces the deduction for mutual company policyholder dividends (or otherwise increases taxable income by reducing the amount of end-of-year reserves) in an equal amount.

The amount of the deduction disallowed by Section 809 is termed the company's differential earnings amount. The differential earnings amount equals the product of the individual company's average equity base and an industry-wide computed differential earnings rate. The average equity base is computed using the company's surplus and capital, adjusted for non-admitted financial assets, the excess of statutory reserves over tax reserves, certain other reserves, and by 50 percent of the provision for policyholder dividends payable in the following year. The differential earnings rate equals the excess of an imputed stock earnings rate (the average stock earnings rate for the prior three years of the 50 largest domestic stock life insurance companies, adjusted by a factor roughly equal to 0.90555) over the average earnings rate of all domestic mutual life insurance companies. The differential earnings rate equals zero if the average mutual earnings rate exceeds the imputed stock earnings rate. The differential earnings rate is initially computed using the average mutual earnings rate for the second year preceding the current taxable year, but is later recomputed using the current year's average mutual earnings rate. Any difference between the differential earnings amount and the recomputed differential earnings amount is taken into account in computing taxable income for the following taxable year.

Section 809 was temporarily suspended by the Job Creation and Work Assistance Act of 2002 (Public Law 107-147). For taxable years beginning in 2001, 2002 and 2003, the differential earnings rate is treated as zero for purposes of computing the differential earnings amount and the recomputed differential earnings amount.

Reasons for Change

Section 809 has never effectively achieved the purpose for which it was intended. In fact, the differential earnings amount has been zero for seven of the last ten years, thus permitting mutual life insurance companies a full deduction for policyholder dividends in those seven years.

Section 809 has been criticized as being theoretically unsound because capital contributions made to stock companies are untaxed to the company, while mutual company capital contributions in the form of life insurance premiums are fully taxed. In essence, mutual companies prepay the tax on income later distributed to policyholders as policyholder dividends.

The computations necessary to determine the differential earnings amount are overly complex. They are flawed because an individual company's tax is based on industry-wide results. Moreover, the computations incorrectly measure the differential earnings rate by comparing a current year mutual earnings rate with a stock earnings rate averaged over three prior years. In addition, the correction attempted by calculating a recomputed differential earnings rate ignores the time value of money. Furthermore, section 809 imposes an additional data reporting burden on both stock and mutual life insurers, but raises relatively little revenue.

Finally, section 809 has become less relevant in recent years, because much of the mutual life insurance industry has demutualized.

Proposal

The proposal would repeal section 809, effective for taxable years beginning in 2004.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-123	-137	-65	-36	-24	-385	-472

PERMANENTLY EXTEND AND EXPAND DISCLOSURE OF TAX RETURN INFORMATION FOR ADMINISTRATION OF STUDENT LOANS

Current Law

The IRS may disclose a taxpayer's filing status, adjusted gross income and identity information to the Department of Education – but not to contractors thereof -- to establish an income contingent repayment amount for a student loan. This provision is scheduled to expire on September 30, 2003.

Reasons for Change

Inasmuch as the Department of Education uses contractors for this purpose, in practice, the necessary disclosures occur under a permanent statutory provision permitting disclosures to contractors upon a student's consent. Consequently, the Department of Education and IRS have to process some 100,000 consents every year. This results in an administrative burden. Moreover, certain student loan programs would benefit from additional disclosure authority.

Proposal

The Administration has proposed legislation that would establish permanent authority to disclose the return information described above and also earnings from employment, Federal income tax liability, and type of tax return filed. Pursuant to the proposal, the Department of Education could use the information not only for establishing a repayment amount but also for verifying items reported by student financial aid applicants and their parents. Such verification would eliminate virtually all Pell Grant overpayments. Finally, the proposal would allow the use of contractors, eliminating the need for consents. In sum, the proposal would support the correct administration of student loans, helping to reduce fraud and error.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
--	--	--	--	--	--	--	--

Temporarily Extend Expiring Provisions

EXTEND AND MODIFY THE WORK OPPORTUNITY TAX CREDIT AND THE WELFARE-TO-WORK TAX CREDIT

Current Law

Under current law, employers are generally entitled to a work opportunity tax credit (WOTC) for the first $6,000 of cash wages paid to several target groups of economically disadvantaged or handicapped workers. The maximum WOTC credit is generally $2,400 per worker. For the summer youth target group, the credit is limited to the first $3,000 of cash wages and the maximum credit is $1,200. For workers employed between 120 and 400 hours, the WOTC credit rate is 25 percent of qualified wages. For workers employed over 400 hours, the WOTC credit rate is 40 percent. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The minimum employment period that employees must work before employers can claim the WOTC credit is 120 hours.

The welfare-to-work (WTW) tax credit enables employers to claim a tax credit for eligible wages paid to certain qualified long-term welfare recipients. The WTW credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. Thus, the maximum credit is $8,500 per qualified employee. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The minimum employment period that employees must work before employers can claim the WTW credit is 400 hours.

Other limitations, including the tax liability limitations governing the general business credit, restrict the amount of WOTC and WTW credits that can be claimed.

Current WOTC target groups include qualified: (1) recipients of Temporary Assistance to Needy Families (TANF); (2) veterans; (3) ex-felons; (4) high-risk youth; (5) participants in State-sponsored vocational rehabilitation programs; (6) summer youth; (7) food stamp recipients; and (8) Supplemental Security Income (SSI) recipients. A qualified long-term welfare recipient for purposes of the WTW credit is: (1) a member of a family that has received TANF for at least 18 consecutive months ending on the hiring date; (2) a member of a family that has received TANF for a total of 18 months after August 5, 1997, provided the hiring date is within two years of the date when the 18-month total is reached; or (3) a member of family ineligible for TANF because of any Federal- or State-imposed time limit, if the family member is hired within two years of the date of benefit cessation.

For the WOTC credit, eligible wages include only cash wages. For the WTW credit, eligible wages include amounts paid by the employer for: (1) educational assistance excludable under a section 127 program; (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

Membership in most WOTC and WTW target groups requires eligible persons to be members of families that benefit from means-tested government programs, to live in areas with high poverty rates, or to have participated in government programs that provide benefits to handicapped workers.[29] However, ex-felons are required to be members of families which have incomes for a specified 6-month period that, when annualized, do not exceed 70 percent of the Lower Living Standard published by the Bureau of Labor Statistics. State employment security agencies are responsible for certifying that individuals are eligible for the credits.

Many workers eligible for the WTW credit are also eligible for WOTC. Employers of such workers may claim either the WOTC or WTW credit, but not both, in any taxable year. The WOTC and WTW credits are effective for workers hired before January 1, 2004.

Reasons for Change

The WOTC and WTW credits provide tax incentives to employers for hiring economically disadvantaged workers, but the rules for computing the credits differ in ways that are hard to justify. Employers of WTW-eligible long-term welfare recipients, who generally are more costly to employ than WOTC workers, receive lower credits in the initial phase of employment than employers of WOTC workers. Because many WTW employees are also eligible for WOTC, employers of these workers compute credits under both sets of rules to determine which credit is most advantageous. To compute WTW credits, employers have to calculate the value of certain fringe benefits paid to each WTW worker hired, which is difficult and costly relative to the expected tax benefits. The family-income test for the WOTC credit's ex-felon target group is burdensome for administrative agencies and reduces employer incentives for hiring ex-felons.

Proposal

The proposal would simplify the employment incentives by combining the credits into one credit and making the rules for computing the combined credit simpler. The credits would be combined by creating a new welfare-to-work target group under the work opportunity tax credit. The minimum employment periods and credit rates for the first year of employment under the present work opportunity tax credit would apply to welfare-to-work employees. The maximum amount of eligible wages would continue to be $10,000 for welfare-to-work employees and generally $6,000 for other target groups ($3,000 for summer youth). In addition, the second-year 50-percent credit currently available under the welfare-to-work credit would continue to be available for welfare-to-work employees under the modified work opportunity tax credit. Qualified wages would be limited to cash wages. The work opportunity tax credit would also be simplified by eliminating the need to determine family income for ex-felons. The modified work opportunity tax credit would apply to individuals who begin work after December 31, 2003, and before January 1, 2006.

[29] A provision of The Job Creation and Worker Assistance Act of 2002 provides a wage credit for New York Liberty Zone Employees by temporarily treating them as members of a WOTC target group.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-54	-201	-268	-181	-96	-800	-873

EXTEND MINIMUM TAX RELIEF FOR INDIVIDUALS

Current Law

An individual is subject to an alternative minimum tax (AMT) to the extent the individual's tentative minimum tax is greater than the regular tax liability. In computing the tentative minimum tax, taxable income is calculated differently than for regular tax purposes. Under the AMT, certain income items are included that are not included for regular tax purposes. Also, certain deductions, including state and local tax deductions, miscellaneous itemized deductions, and the standard deduction, are not permitted. A specified exemption amount, which varies by filing status but not by the number of personal exemptions and which phases out at higher income levels, is allowed, but the regular tax personal exemptions for taxpayers and their dependents are not allowed in computing the AMT.

A temporary provision, which permitted an individual to reduce tax liability by the full amount of nonrefundable personal credits even if tax liability is reduced to an amount that is less than the individual's tentative minimum tax, expired after taxable year 2001 but was extended for taxable years 2002 and 2003 by the Job Creation and Worker Assistance Act of 2002. The extension does not apply to the child credit, earned income tax credit, or the adoption credit which were provided AMT relief through taxable year 2010 under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The refundable portions of the child credit and the earned income tax credit are also allowed against the AMT through taxable year 2010.

EGTRRA increased the AMT exemption for taxable years 2001 through 2004 from $33,750 to $35,750 for single and head of household filers, from $45,000 to $49,000 for married taxpayers filing joint returns, and from $22,500 to $24,500 for married taxpayers filing separate returns. Effective for taxable years beginning after December 31, 2004, the AMT exemption amounts will decline to their pre-EGTRRA levels.

Reasons for Change

The original individual minimum tax was enacted to ensure that taxpayers with substantial amounts of economic income did not avoid significant tax liability by using exclusions, deductions, and credits. The Administration is concerned that the individual AMT may impose financial and compliance burdens upon taxpayers who were not the originally intended targets of the individual AMT. The Administration believes that allowing full use of nonrefundable personal credits, all of which are limited in amount and which are generally limited to lower- and middle-income families, would not undermine the policy of the individual AMT and would promote the important social policies underlying the credits.

The Administration believes that allowing nonrefundable personal credits to be used in full and allowing the larger AMT exemption would avoid a significant increase in compliance burdens. Substantially fewer taxpayers would need to perform complex and tedious computations to determine whether the AMT limited the use of these credits.

Proposal

The proposal would allow an individual to reduce tax liability by the full amount of nonrefundable personal credits even if tax liability is reduced to an amount that is less than the individual's tentative minimum tax. The larger AMT exemption levels provided temporarily by EGTRRA would continue.

The proposal would be effective for taxable years through 2005.

The adoption credit and both the regular and refundable portions of the child credit and the earned income tax credit would remain refundable for taxable years after 2010 as the result of the Administration's proposal to permanently extend all provisions of EGTRRA.

Revenue Estimate[30]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-260	-4,045	-5,482	0	0	-9,787	-9,787

[30] This revenue estimate revises the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004*.

EXTEND THE DISTRICT OF COLUMBIA (DC) ENTERPRISE ZONE

Current Law

The DC Zone includes the D.C. Enterprise Community and District of Columbia census tracts with a poverty rate of at least 20 percent. Certain businesses in the zone are eligible for (1) a wage credit equal to 20 percent of the first $15,000 in annual wages paid to qualified employees who reside within the District of Columbia; (2) $35,000 in increased section 179 expensing (a provision focused on small business; see page 22); and (3) in certain circumstances, tax-exempt bond financing. In addition, gross income does not include capital gain from the sale of qualified DC Zone assets held more than 5 years. For purposes of the capital gain exclusion, the DC Zone includes all DC census tracts with a poverty rate of at least 10 percent. Gain on DC Zone assets attributable to the periods before January 1, 1998, and after December 31, 2008, is not eligible for the exclusion.

The DC Zone incentives apply for the period from January 1, 1998, through December 31, 2003, and with respect to bonds issued and DC Zone assets acquired during that period.

Reasons for Change

Despite recent economic growth in the region, certain portions of the District of Columbia are still characterized by high levels of poverty, unemployment and other indicators of economic distress. Extending the DC Zone incentives would encourage the continued economic redevelopment of these areas.

Proposal

The DC Zone incentives would be extended for two years, making the incentives applicable through December 31, 2005, and with respect to bonds issued and DC Zone assets acquired during 2004 and 2005. The capital gain eligible for the exclusion would also be expanded to include gain attributable to the period from January 1, 2009, through December 31, 2010.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	-54	-98	-40	1	-4	-195	-320

EXTEND THE FIRST-TIME HOMEBUYER CREDIT FOR THE DISTRICT OF COLUMBIA

Current Law

A one-time, non-refundable $5,000 credit is available to purchasers of a principal residence in the District of Columbia who have not owned a residence in the District during the year preceding the purchase. The credit phases out for taxpayers with modified adjusted gross income between $70,000 and $90,000 ($110,000 and $130,000 for joint returns).

The credit does not apply to purchases after December 31, 2003.

Reasons for Change

The homeownership rate in the District of Columbia is significantly below the rate for neighboring states and the nation as a whole. Homeownership fosters healthy, vibrant communities and is a key to revitalizing the Nation's capital. Extending the credit would enhance the District's ability to attract new homeowners and establish a stable residential base.

Proposal

The first-time homebuyer credit for the District of Columbia would be extended for two years, making the credit available with respect to purchases through December 31, 2005.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
0	1	-18	-18	-2	0	-37	-37

EXTEND AUTHORITY TO ISSUE QUALIFIED ZONE ACADEMY BONDS

Current Law

Under current law, State and local governments can issue qualified zone academy bonds (QZABs) to fund the improvement of certain eligible public schools. An eligible holder of a QZAB receives annual Federal income tax credits. These annual credits compensate the holder for lending money and, therefore, are treated like taxable interest payments for Federal tax purposes. Eligible holders are banks, insurance companies, and corporations actively engaged in the business of lending money. The credit rate for a QZAB is set on its day of sale by reference to credit rates established by the Department of the Treasury. The maximum term of a QZAB issued during any month is determined by reference to the adjusted applicable Federal rate (AFR) published by the Internal Revenue Service for the month in which the bond is issued. The higher the AFR, the shorter the maximum term (rounded to whole years) so as to keep the extent of the Federal subsidy approximately equal to half the face amount of the bond.

Current law establishes authority to issue $400 million of QZABs for each year from 1998 through 2003. The annual cap is allocated among the States in proportion to their respective populations of individuals with incomes below the poverty line. Unused authority to issue QZABs may be carried forward for two years (three years for authority arising in 1998 and 1999) after the year for which the authority was established.

A number of requirements must be met for a bond to be treated as a QZAB. First, the bond must be issued pursuant to an allocation of bond authority from the issuer's State educational agency. Second, at least 95 percent of the bond proceeds must be used for an eligible purpose at a qualified zone academy. Eligible purposes include rehabilitating school facilities, acquiring equipment, developing course materials, or training teachers. A qualified zone academy is a public school (or an academic program within a public school) that is designed in cooperation with business and is either (1) located in an empowerment zone or enterprise community, or (2) attended by students at least 35 percent of whom are estimated to be eligible for free or reduced-cost lunches under the National School Lunch Act. Third, private entities must have promised to contribute to the qualified zone academy certain property or services with a present value equal to at least 10 percent of the bond proceeds. There is no requirement that issuers of QZABs report issuance to the Internal Revenue Service (IRS). Issuers of tax-exempt bonds must report issuance to the IRS by filing information returns.

Reasons for Change

Aging school buildings and new educational technologies create a need to renovate older school buildings and to develop new curricula. Many school systems have insufficient fiscal capacity to finance needed renovation and programs. The QZAB provision encourages the development of innovative school programs through public/private partnerships. A reporting requirement would facilitate evaluation of this provision and assist in its administration by the IRS.

Proposal

The authority to issue $400 million of QZABs per year would be extended for two years to 2004 and 2005. For QZABs issued after December 31, 2003, issuers would be required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

Revenue Estimate[31]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-3	-9	-17	-26	-32	-87	-257

[31] This revenue estimate revises the estimate included in Table 4-3 of *Analytical Perspective of the Budget of the United States Government for Fiscal Year 2004*.

EXTEND DEDUCTION FOR CORPORATE DONATIONS OF COMPUTER TECHNOLOGY

Current Law

The deduction for charitable contributions of ordinary income property is generally limited to the lesser of the taxpayer's cost basis in the property or fair market value. The Taxpayer Relief Act of 1997 provided an enhanced deduction for a three-year period for charitable contributions of computer technology or equipment to elementary and secondary schools and charities formed for the purpose of supporting elementary and secondary education. In 2000, this provision was extended for an additional three-year period and expanded to apply to charitable contributions of computer technology or equipment to post-secondary educational institutions and public libraries. Under this provision, the amount of the deduction is equal to the taxpayer's basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. The enhanced deduction is limited to twice the taxpayer's basis in the donated property. To qualify for the enhanced deduction, the contribution must satisfy various requirements. This enhanced deduction provision is scheduled to expire for taxable years beginning after December 31, 2003.

Reasons for Change

This provision provides an incentive for businesses to contribute computer equipment and software for the benefit of local communities and students at the elementary, secondary, and post-secondary school levels, by providing public libraries and educational institutions with needed technological resources. Because the need for technological resources is continuing, this provision should be extended.

Proposal

The Administration proposes to extend the deduction, which expires with respect to donations made after December 31, 2003, to apply to donations made before January 1, 2006.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	-74	-127	-52	0	0	-253	-253

EXTEND THE WAIVER OF THE ALTERNATIVE MINIMUM TAX LIMITATION ON NOL USE

Current Law

A net operating loss (NOL) generally is the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. NOLs generally may be carried back two years, resulting in a refund of taxes paid in the carryback year, or carried forward for twenty years, resulting in lower tax payments for the carryforward year. However, NOL deductions may not reduce a taxpayer's alternative minimum taxable income (AMTI) by more than 90 percent. The Job Creation and Worker Assistance Act of 2002 temporarily waived the AMTI limitation for NOL carrybacks arising in taxable years ending in 2001 and 2002 as well as for NOL carryforwards to those years.

Reasons for Change

The AMTI limitation is inconsistent with measuring net income, is overly burdensome, and prevents appropriate tax relief to firms in difficult financial straits.

Proposal

The Administration's proposal would waive the AMTI limitation for NOL carrybacks originating in taxable years ending in 2003, 2004, and 2005, as well as for NOLs carried forward into those years.

Revenue Estimate[32]

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-2008	2004-2013
($'s in millions)							
-202	-1,070	-689	-98	190	151	-1,516	-1,031

[32] Estimate stacked after proposal to eliminate double taxation of corporate earnings.

EXTEND IRS USER FEES

Current Law

The IRS is authorized to charge user fees for written responses to questions from individuals, corporations, and organizations related to their tax status or the effects of particular transactions for tax purposes. Under current law, these fees are scheduled to expire effective with requests made after September 30, 2003.

Reasons for Change

The existing provision permits the IRS to recover its costs for providing written responses to taxpayer questions that, with certain exceptions, are binding upon the IRS. Preparing such written responses typically requires significant IRS resources and, in the absence of authority to charge user fees, would require the IRS to reduce its resources devoted to other priorities.

Proposal

The proposal would extend for two years, through September 30, 2005, the IRS's authority to charge user fees for written responses to questions from individuals, corporations, and organizations related to their tax status or the effects of particular transactions for tax purposes.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
0	68	81	6	0	0	155	155

EXTEND PROVISIONS PERMITTING DISCLOSURE OF RETURN INFORMATION RELATING TO TERRORIST ACTIVITY

Current Law

Current law permits disclosure of return information relating to terrorism in two situations. First, if the IRS wishes to apprise a Federal law enforcement agency of a terrorist incident, threat or activity, the IRS may disclose a taxpayer's identity and return information to such agency's head (who in turn may disclose such information to agency officers and employees as necessary). Second, if the head (or delegate) or executive of a Federal law enforcement or intelligence agency submits a written request, the IRS may disclose a taxpayer's identity and return information to such agency's officers and employees involved with a terrorist incident, threat or activity. The head of a Federal law enforcement agency in turn may make disclosures to State or local law enforcement agencies working as part of a team on the investigation or response.

For disclosure of returns and return information filed by the taxpayer himself to Federal law enforcement or intelligence agency officers and employees, it is necessary to obtain a court order indicating there is reasonable cause to believe the returns and return information are relevant to the terrorist incident, threat or activity. In the first situation, the IRS may apply for an ex parte court order, making disclosures to the Department of Justice as necessary to prepare such application on behalf of the IRS. In the second situation, specified officials in the Department of Justice may apply for an ex parte court order.

Reasons for Change

This disclosure authority relating to terrorist activities is scheduled to expire on December 31, 2003. Additional time would allow for study of the effectiveness of the provision.

Proposal

The Administration proposes to extend this authority for one year, until December 31, 2004, to provide continued support for investigations and responses relating to terrorism.

Revenue Estimate

Fiscal Years							
2003	2004	2005	2006	2007	2008	2004-08	2004-13
$'s in millions							
--	--	--	--	--	--	--	--

RESPOND TO FOREIGN SALES CORPORATION/EXTRATERRITORIAL INCOME DECISIONS

Current Law

The United States, like several of our major trading partners, operates a worldwide system of income taxation. U.S. citizens and residents, including U.S. corporations, are taxed on all their income, regardless of where it is earned. Income earned from foreign sources potentially is subject to taxation both by the country where the income is earned, the country of source, and by the United States, the country of residence. To provide relief from this potential double taxation, the United States allows taxpayers a foreign tax credit that reduces the U.S. tax on foreign-source income by the amount of foreign income and withholding taxes paid on such income. A U.S. corporation generally is subject to U.S. tax on the active earnings of a foreign subsidiary if and when such income is repatriated as a dividend. However, under the subpart F rules, the U.S. parent is subject to current U.S. tax on certain income earned by a foreign subsidiary, without regard to whether that income is distributed to the U.S. parent.

The extraterritorial income exclusion (ETI) provisions, which provide a partial exemption from tax for income from certain foreign sales and leasing transactions, were enacted in 2000 to replace the foreign sales corporation (FSC) provisions of prior law. In January 2002, the WTO Dispute Settlement Body adopted a final report finding that the ETI provisions, like the prior-law FSC provisions, are inconsistent with WTO rules. The WTO has authorized the imposition of trade sanctions against U.S. exports up to the level of $4 billion per year.

Reasons for Change

The United States must comply with the WTO rulings in the FSC/ETI case. In doing so, our focus should be on the global competitiveness of U.S.-based businesses and American workers and the impact of the U.S. international tax rules. The Administration will work with the Congress to develop and enact legislation that makes meaningful changes to our tax law to satisfy the twin goals of honoring our WTO obligations and preserving the competitiveness of U.S. businesses operating in the global marketplace.

The international provisions of our tax code have not kept pace with the changes in our economy. International tax policy remains rooted in tax principles developed in the 1950s and 1960s. That was a time when America's foreign direct investment was preeminent abroad and competition from imports to the United States was modest. Today, we have a truly global economy, in terms of both trade and investment. The value of goods traded to and from the United States increased more than three times faster than GDP between 1960 and 2000, rising to more than 20 percent of GDP. The flow of cross-border investment, both inflows and outflows, rose from 1.1 percent of GDP in 1960 to 15.9 percent of GDP in 2000.

The globalization of the world economy has provided tremendous benefits to consumers and workers. The potential for a world market encourages companies to invest in research that leads to continuous innovation. At one time, the strength of America's economy was thought to be tied to its abundant natural resources. Today, America's strength is its ability to innovate: to create new technologies and to react faster and smarter to the commercialization of these technologies.

The principles that guided tax policy adequately in the past should be reconsidered in today's highly competitive, knowledge-driven economy. In order to ensure the ability of U.S. workers to achieve higher living standards, we must ensure that the U.S. tax law does not operate to hinder the ability of the U.S. businesses that employ those workers to compete on a global scale.

Proposal

Compliance with the WTO decisions in the FSC/ETI case requires substantive changes to our current international tax laws. Replicating the benefits of the FSC and ETI provisions through minor changes to the current-law ETI provisions or through enactment of a similar replacement regime will not bring us into compliance with the WTO rules as analyzed in the decisions. Compliance will require repeal of the ETI provisions. The required changes to our tax law should be coupled with much needed reforms to ensure that our tax law, and our international tax system in particular, does not operate to impose anti-competitive burdens on U.S.-based companies operating in the global marketplace.

We intend to work closely with the Congress to develop and enact the reforms needed to rationalize our international tax rules. The U.S. international tax rules can operate to impose a burden on U.S.-based companies disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity. That complexity itself represents a significant burden that should be addressed.

One area of attention for reform efforts is the subpart F rules. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends beyond passive income to encompass some forms of income from active foreign business operations. Several categories of active business income are covered by the subpart F rules. For example, under subpart F, a U.S. parent company is subject to current U.S. tax on income earned by a foreign subsidiary from certain sales transactions. Accordingly, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. The subpart F rules also impose current U.S. tax on income from certain services transactions performed abroad. While the subpart F rules are intended to differentiate passive or mobile income from active business income, they can operate to subject to current tax some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to tax considerations.

Another area of focus is the foreign tax credit rules. The rules for determining and applying the current-law foreign tax credit limitation are detailed and complex and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. The current U.S. foreign tax credit regime also requires that the rules be applied separately to separate categories or "baskets" of income. Foreign taxes paid with respect to income in a particular category may be used only to offset the U.S. tax on income from that same category.

Computations of foreign and domestic source income, allocable expenses, and foreign taxes paid must be made separately for each of these separate foreign tax credit baskets, further adding to the complexity of the system.

The expense allocation rules for foreign tax credit purposes can treat interest expense of a U.S. group as relating to the group's foreign subsidiaries even where those subsidiaries are equally or more highly leveraged than the U.S. group. This can result in an over-allocation of interest expense to foreign income, understating foreign income and reducing the foreign tax credit limitation. The rules that apply to taxpayers with overall losses from their domestic operations also can operate to restrict the foreign tax credit. An overall loss in the United States would offset income earned from foreign operations, income on which foreign taxes have been paid, and thus would reduce the U.S. company's ability to claim foreign tax credits for those foreign taxes paid. These limitation rules can have the effect of denying U.S.-based companies the full ability to credit foreign taxes paid on income earned abroad against the U.S. tax liability with respect to that income and therefore can result in the imposition of the double taxation that the foreign tax credit rules are intended to eliminate.

The foregoing are examples of particular areas that deserve attention. A complete reexamination of all of the U.S. international tax rules is needed to ensure that the U.S. tax rules do not adversely impact the ability of American workers and U.S. businesses to compete successfully around the world. Relative to the tax systems of our major trading partners, the U.S. international tax rules can impose significantly heavier burdens on domestically based companies. As we make the changes to our tax law that are needed to comply with WTO rules, we must keep our focus on the objectives served by the FSC and ETI provisions and look to removing biases against the ability of U.S. businesses to compete in today's global economy.

The Administration is committed to working with Congress to satisfy the objectives of meeting our WTO obligations and ensuring that we protect the competitive position of American workers and businesses.

Revenue Estimates 1/
FY 2004 Budget Proposals Affecting Receipts

	Effective Date	Fiscal Years 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2008	2004-2013
							($'s in millions)							
Economic Growth Package: 2/														
Accelerate 10-percent individual income tax rate bracket expansion	tyba 12/31/02	-978	-7,782	-6,112	-6,117	-6,495	-4,275	-3,227	-3,283	-3,326	-3,294	-3,283	-30,781	-47,194
Accelerate reduction in individual income tax rates	tyba 12/31/02	-5,808	-35,693	-17,470	-4,939	0	0	0	0	0	0	0	-58,102	-58,102
Accelerate 15-percent individual income tax rate bracket expansion for married taxpayers filing joint return	tyba 12/31/02	-2,042	-19,889	-10,171	-4,718	-1,785	-463	0	0	0	0	0	-37,026	-37,026
Accelerate increase in standard deduction for married taxpayers filing joint returns	tyba 12/31/02	-735	-7,245	-4,509	-2,924	-1,811	-1,272	-424	0	0	0	0	-17,761	-18,185
Accelerate increase in child tax credit 3/	tyba 12/31/02	-13,827	-6,134	-15,518	-12,806	-12,727	-12,644	-11,848	-6,868	0	0	0	-59,829	-78,545
Eliminate the double taxation of corporate earnings 4/	dima 12/31/02	-2,665	-24,224	-25,962	-31,501	-33,996	-36,983	-40,245	-43,492	-46,445	-49,545	-53,036	-152,666	-385,429
Increase expensing for small business	tyba 12/31/02	-1,023	-1,652	-1,776	-1,912	-1,601	-1,431	-1,256	-1,170	-1,235	-1,259	-1,291	-8,372	-14,583
Provide minimum tax relief to individuals	tyba 12/31/02	-3,141	-8,534	-10,353	-6,931	0	0	0	0	0	0	0	-25,818	-25,818
Total Economic Growth Package		**-30,219**	**-111,153**	**-91,871**	**-71,848**	**-58,415**	**-57,068**	**-57,000**	**-54,813**	**-51,006**	**-54,098**	**-57,610**	**-390,355**	**-664,882**
Tax Incentives: 2/														
Provide incentives for charitable giving:														
Provide charitable contribution deduction for nonitemizers	tyba 12/31/02	-199	-1,358	-1,067	-1,128	-1,177	-1,214	-1,246	-1,296	-1,340	-1,365	-1,380	-5,944	-12,571
Permit tax-free withdrawals from IRAs for charitable contributions	tyba 12/31/02	-66	-437	-361	-376	-382	-388	-394	-400	-417	-445	-476	-1,944	-4,076
Expand and increase the enhanced charitable deduction for contributions of food inventory	tyba 12/31/02	-19	-54	-59	-66	-72	-79	-88	-97	-107	-118	-132	-330	-872
Reform excise tax based on investment income of private foundations 5/	tyba 12/31/02	-15	-159	-110	-115	-120	-128	-137	-146	-154	-161	-169	-632	-1,399
Modify tax on unrelated business taxable income of charitable remainder trusts	tyba 12/31/02	-1	-3	-4	-4	-4	-4	-6	-6	-6	-7	-7	-19	-51
Modify basis adjustment to stock of S corporations contributing appreciated property	tyba 12/31/02	0	-12	-11	-14	-16	-19	-22	-25	-29	-32	-36	-72	-216
Repeal the $150 million limitation on qualified 501(c)(3) bonds	biadoe	-2	-6	-9	-10	-9	-9	-8	-8	-8	-8	-7	-43	-82
Repeal restrictions on the use of qualified 501(c)(3) bonds for residential rental property	biadoe	0	-2	-6	-11	-17	-24	-30	-37	-44	-49	-56	-60	-276
Strengthen and reform education:														
Provide refundable tax credit for certain costs of attending a different school for pupils assigned to failing public schools 6/	eibi 03-04 sy	0	-226	-572	-752	-838	-932	-498	0	0	0	0	-3,320	-3,818
Extend, increase and expand the above-the-line deduction for qualified out-of-pocket classroom expenses	tyba 12/31/03	--	-23	-229	-240	-249	-260	-263	-266	-270	-274	-278	-1,001	-2,352
Invest in health care:														
Provide refundable tax credit for the purchase of health insurance 7/	tyba 12/31/03	--	-324	-4,995	-9,055	-9,660	-9,966	-10,419	-10,657	-10,992	-11,342	-11,748	-34,000	-89,158
Provide an above-the-line deduction for long-term care insurance premiums	tyba 12/31/03	--	-112	-559	-984	-1,923	-3,063	-3,667	-3,784	-4,230	-4,716	-5,217	-6,641	-28,255
Allow up to $500 in unused benefits in a health flexible spending arrangement to be carried forward to the next year	pyba 12/31/03	--	-367	-640	-723	-782	-830	-878	-926	-980	-1,085	-1,174	-3,342	-8,385
Provide additional choice with regard to unused benefits in a health flexible spending arrangement	pyba 12/31/03	--	-19	-33	-39	-45	-52	-60	-69	-81	-94	-103	-188	-595
Permanently extend and reform Archer MSAs	tyba 12/31/03	--	-26	-284	-432	-486	-549	-582	-608	-654	-709	-804	-1,777	-5,134
Provide an additional personal exemption to home caregivers of family members	tyba 12/31/03	--	-70	-465	-437	-422	-417	-423	-412	-427	-416	-403	-1,811	-3,892
Allow the orphan drug tax credit for certain pre-designation expenses	qeia 12/31/02	0	-*	-*	-1	-1	-1	-1	-1	-1	-1	-1	-3	-8
Encourage telecommuting:														
Exclude from income the value of employer-provided computers, software and peripherals	tyba 12/31/03	--	-35	-51	-53	-54	-56	-57	-59	-61	-63	-65	-249	-554
Increase housing opportunities:														
Provide tax credit for developers of affordable single-family housing	1/1/2004	--	-7	-78	-315	-750	-1,316	-1,932	-2,499	-2,904	-3,117	-3,215	-2,466	-16,133
Establish Individual Development Accounts (IDAs)	1/1/2005	--	--	-124	-267	-319	-300	-255	-91	3	3	3	-1,010	-1,347
Protect the environment:														
Permanently extend expensing of brownfields remediation costs	qepoia 12/31/03	--	-185	-282	-268	-257	-248	-239	-230	-223	-216	-208	-1,240	-2,356
Exclude 50 percent of gains from the sale of property for conservation purposes 4/	sa 12/31/03	--	-19	-39	-41	-42	-44	-46	-48	-51	-56	-61	-185	-447
Increase energy production and promote energy conservation:														
Extend and modify the tax credit for producing electricity from certain sources	various	-124	-264	-355	-209	-90	-92	-94	-95	-97	-99	-97	-1,010	-1,492
Provide tax credit for residential solar energy systems	episa 12/31/02	-4	-7	-10	-18	-25	-11	0	0	0	0	0	-71	-71
Modify treatment of nuclear decommissioning funds	tyba 12/31/02	-14	-251	-180	-191	-201	-212	-222	-233	-245	-256	-269	-1,035	-2,260
Provide tax credit for purchase of certain hybrid and fuel cell vehicles	pma 12/31/02	-44	-154	-316	-524	-793	-631	-87	-97	-133	-193	-274	-2,418	-3,202
Provide tax credit for energy produced from landfill gas	fpisa 12/31/02	-5	-28	-65	-88	-99	-112	-125	-135	-55	0	0	-392	-707
Provide tax credit for combined heat and power property 4/	episa 12/31/02	-18	-99	-68	-63	-76	-14	20	9	6	5	3	-320	-277
Provide excise tax exemption (credit) for ethanol	10/1/2007					*No Revenue Effect*								
Total Tax Incentives		**-511**	**-4,247**	**-10,972**	**-16,424**	**-18,909**	**-20,971**	**-21,759**	**-22,216**	**-23,500**	**-24,814**	**-26,174**	**-71,523**	**-189,986**

	Effective Date	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2004-2008	2004-2013
							Fiscal Years ($'s in millions)							
Trade, Tax Administration and Unemployment Insurance														
Promote trade:														
Implement free trade agreements with Chile and Singapore 8/ 9/		--	-25	-51	-68	-80	-92	-104	-112	-120	-127	-134	-316	-913
Improve tax administration:														
Modify the IRS Restructuring and Reform Act of 1998 (RRA98)														
Make section 1203 of the IRS Restructuring and Reform Act of 1998 more effective and fair	doe					*No Revenue Effect*								
Curb the use of frivolous submissions and filings made to impede or delay tax administration	doe					*No Revenue Effect*								
Authorize partial-liability installment agreements	doe	0	78	54	56	57	59	60	62	64	66	68	304	624
Allow for the termination of installment agreements for failure to file returns and for failure to make tax deposits	doe					*No Revenue Effect*								
Consolidate judicial review of collection due process cases in the United States Tax Court	doe					*No Revenue Effect*								
Eliminate the monetary threshold for counsel review of offers in compromise	doe					*No Revenue Effect*								
Initiate IRS Cost Saving Measures														
Allow the financial management service to retain transaction fees from levied amounts	doe					*No Revenue Effect*								
Extend the due date for electronically filed returns	tyba 12/31/02					*No Revenue Effect*								
Repeal section 132 of the Revenue Act of 1978 and amend the tax code to authorize the Secretary of the Treasury to issue rules to address inappropriate nonqualified deferred compensation arrangements	doe					*No Revenue Effect*								
Permit private collection agencies to engage in specific, limited activities to support IRS collection efforts	doe	0	46	128	111	94	97	100	103	106	110	113	476	1,008
Combat abusive tax avoidance transactions	doe	12	45	83	98	99	103	106	111	116	121	125	428	1,007
Limit related party interest deductions 4/	tyba 12/31/03	--	11	109	198	251	307	368	434	506	583	667	876	3,434
Reform unemployment insurance:														
Reform unemployment insurance administrative financing 9/	1/1/2005	--	--	-1,068	-1,440	-3,371	-2,017	-2,339	-3,658	295	132	54	-7,896	-13,412
Total Trade, Tax Administration and Unemployment Insurance		**12**	**155**	**-745**	**-1,045**	**-2,950**	**-1,543**	**-1,809**	**-3,060**	**967**	**885**	**893**	**-6,128**	**-8,252**
Other Proposals:														
Deposit full amount of excise tax imposed on gasohol in the Highway Trust Fund 8/ 9/	ca 9/30/03	--	0	0	558	576	590	607	622	638	652	669	1,724	4,912
Increase Indian gaming activity fees 8/	--	0	0	3	4	4	5	5	5	5	5	5	16	41
Total Other Proposals		**0**	**0**	**3**	**562**	**580**	**595**	**612**	**627**	**643**	**657**	**674**	**1,740**	**4,953**
Simplify the Tax Laws: 2/														
Establish uniform definition of a qualifying child 4/	tyba 12/31/03	--	-26	-23	-24	-28	-19	-21	-16	-11	-7	-19	-120	-194
Simplify adoption tax provisions	tyba 12/31/02	-4	-36	-37	-39	-40	-42	-43	-45	-47	-49	-51	-194	-429
Expand tax-free savings opportunities	1/1/2003	1,390	10,572	4,803	1,915	-648	-1,822	-1,925	-2,358	-2,724	-2,891	-2,920	14,820	2,002
Consolidate employer-based savings accounts 4/	1/1/2004	--	-171	-253	-263	-277	-293	-310	-331	-349	-367	-386	-1,257	-3,000
Total Simplify the Tax Laws		**1,386**	**10,339**	**4,490**	**1,589**	**-993**	**-2,176**	**-2,299**	**-2,750**	**-3,131**	**-3,314**	**-3,376**	**13,249**	**-1,621**
Expiring Provisions:														
Permanently extend expiring provisions:														
Permanently extend provisions expiring in 2010:														
Marginal individual income tax rate reductions	doe	0	0	0	0	0	0	0	0	-70,543	-107,428	-108,979	0	-286,950
Child tax credit 10/	doe	0	0	0	0	0	0	0	0	-4,910	-31,325	-31,439	0	-67,674
Marriage penalty relief 11/	doe	0	0	0	0	0	0	0	0	-4,766	-10,105	-9,527	0	-24,398
Education incentives	doe	-2	-11	-19	-27	-33	-42	-52	-60	-905	-1,727	-1,809	-132	-4,685
Repeal of estate and generation-skipping transfer taxes, and modification of gift taxes	doe	46	-292	-810	-1,319	-1,540	-1,736	-2,149	-2,688	-21,275	-48,136	-46,046	-5,697	-125,991
Modifications of IRAs and pension plans	doe	0	0	0	0	0	0	0	0	-2,110	-4,332	-4,794	0	-11,236
Other incentives for families and children	doe	0	0	0	0	0	0	0	14	-192	-927	-928	0	-2,033
Subtotal; Permanently extend provisions expiring in 2010		44	-303	-829	-1,346	-1,573	-1,778	-2,201	-2,734	-104,701	-203,980	-203,522	-5,829	-522,967
Other provisions:														
Permanently extend research and experimentation (R&E) tax credit	qreia 6/30/04	--	-1,005	-3,278	-5,187	-6,291	-7,129	-7,775	-8,347	-8,961	-9,619	-10,330	-22,890	-67,922
Repeal the disallowance of certain deductions of mutual life insurance companies	tybi 2004	--	-123	-137	-65	-36	-24	-20	-18	-17	-16	-16	-385	-472
Permanently extend and expand disclosure of tax return information for Administration of student loans	10/1/2003					*No Revenue Effect*								
Temporarily extend expiring provisions:														
Extend and modify work opportunity tax credit and the welfare-to-work tax credit	ibwa 12/31/03	--	-54	-201	-268	-181	-96	-52	-18	-3	0	0	-800	-873
Extend minimum tax relief for individuals 4/	tyba 12/31/03	--	-260	-4,045	-5,482	0	0	0	0	0	0	0	-9,787	-9,787
Extend the District of Columbia (DC) Enterprise Zone	1/1/2004	--	-54	-98	-40	1	-4	-16	-31	-30	-25	-23	-195	-320
Extend the first-time homebuyer credit for the District of Columbia	pa 12/31/03	--	1	-18	-18	-2	0	0	0	0	0	0	-37	-37
Extend authority to issue Qualified Zone Academy Bonds 4/	1/1/2004	--	-3	-9	-17	-26	-32	-34	-34	-34	-34	-34	-87	-257
Extend deduction for corporate donations of computer technology	doma 12/31/03	--	-74	-127	-52	0	0	0	0	0	0	0	-253	-253

	Effective Date	2003	2004	2005	2006	2007	Fiscal Years 2008	2009	2010	2011	2012	2013	2004-2008	2004-2013
							($'s in millions)							
Extend the waiver of the Alternative Minimum Tax limitation on NOL use 5/	tyei 2003	-202	-1,070	-689	-98	190	151	123	106	95	85	76	-1,516	-1,031
Extend IRS user fees	rma 9/30/03	--	68	81	6	0	0	0	0	0	0	0	155	155
Extend provision permitting IRS to disclose return information to inform officials of terrorist activities	1/1/2004					*No Revenue Effect*								
Extend provision permitting disclosure of information relating to terrorist activities upon request of Federal law enforcement or intelligence agency	1/1/2004					*No Revenue Effect*								
Extend abandoned mine reclamation fees	--	0	0	308	313	319	325	331	337	343	348	354	1,265	2,978
Total Expiring Provisions		**-158**	**-2,877**	**-9,042**	**-12,254**	**-7,599**	**-8,587**	**-9,644**	**-10,739**	**-113,308**	**-213,241**	**-213,495**	**-40,359**	**-600,786**
Total Effect of Proposals		**-29,490**	**-107,783**	**-108,137**	**-99,420**	**-88,286**	**-89,750**	**-91,899**	**-92,951**	**-189,335**	**-293,925**	**-299,088**	**-493,376**	**-1,460,574**

Department of the Treasury
Office of Tax Analysis

1/ Estimates for several provisions differ from estimates included in Table 4-3 of the Analytical Perspectives of the President's Budget, which presents only the effect on receipts of the Administration's legislative proposals. Estimates presented here for certain provisions identified below, include the effects on both receipts and outlays. Moreover, certain estimates were revised as proposals were finalized.
2/ Estimates stacked after the proposals to extend provisions expiring in 2010 and extending minimum tax relief to individuals.
3/ Affects both receipts and outlays. The outlay effects are $300 million for 2003, $1,074 million for 2004, $4,783 million for 2005, $4,272 million for 2006, $4,195 million for 2007, $4,142 million for 2008, $4,102 million for 2009, $2,671 million for 2010, $18,466 million for 2004-2008, and $25,239 million for 2004-2013.
4/ This revenue estimate revises the estimate included in Table 4-3 of the Analytical Perspectives of the President's Budget.
5/ Estimate stacked after proposal to eliminate double taxation of corporate earnings.
6/ Affects both receipts and outlays. The outlay effects are $213 million for 2004, $543 million for 2005, $714 million for 2006, $796 million for 2007, $886 million for 2008, $474 million for 2009, $3,152 million for 2004-2008, and $3,626 million for 2004-2013.
7/ Affects both receipts and outlays. The outlay effects are $3,546 million for 2005, $8,166 million for 2006, $9,251 million for 2007, $9,827 million for 2008, $10,549 million for 2009, $10,934 million for 2010, $11,365 million for 2011, $11,765 million for 2012, $12,205 million for 2013, $30,790 million for 2004-2008, and $87,608 million for 2004-2013.
8/ The proposal affects receipts and is included in the FY 2004 Budget, but is not described in these General Explanations.
9/ Estimate is net of income tax offsets
10/ Affects both receipts and outlays. The outlay effects are $99 million for 2011, $10,371 million for 2012, $10,311 million for 2013, and $20,781 million for 2004-2013.
11/ Affects both receipts and outlays. The outlay effect is -$319 million for 2011, $2,033 million for 2012, $2,030 million for 2013, and $3,744 million for 2004-2013.

Effective Date Legend:
tyba=taxable years beginning after
dima=distributions made after
bia=bonds issued after
eibi 03-04 sy=expenses incurred beginning in 2003-2004 school year
pyba=plan years beginning after
qeia=qualified expenses incurred after
qepoia=qualified expenditures paid or incurred after
sa=sales after
episa=equipment placed in service after
pma=purchases made after
fpisa=facilities placed in service after
ca=collections after
ibwa=individuals beginning work after
pa=purchases after
doma=donations made after
tyei=tax years ending in
rma=requests made after
qreia=qualified research expenses incurred after
tybi=taxable years beginning in