General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals

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GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2005 REVENUE PROPOSALS

Introduction

This report summarizes the revenue proposals in the Administration's Fiscal Year 2005 Budget. These proposals include making permanent the tax cuts enacted in 2001 and 2003, which is essential for promoting economic growth and higher levels of income in the future. The other proposals, also intended to strengthen the American economy, affect a wide range of areas including encouraging saving, investing in health care, providing incentives for charitable giving, strengthening education, encouraging telecommuting, increasing housing opportunities, protecting the environment, and increasing energy production and promoting energy conservation as well as simplifying the tax laws. Additionally included are proposals to strengthen the employer based pension system, close loopholes and improve tax compliance, improve tax administration as well as proposals related to highway reauthorization and proposals to extend expiring tax provisions.

The Administration's ongoing tax simplification project, which is focusing on immediately achievable reforms of the current tax system, has produced several proposals that appear in this year's Budget. In addition to the nine proposals appearing under the heading, Simplify the Tax Laws for Families, the simplification proposals include expanding tax-free savings opportunities, consolidating employer based savings accounts, simplifying use of the orphan drug tax credit for pre-designation costs, repealing the $150 million limitation on qualified 501(c)(3) bonds, repealing restrictions on the use of qualified 501(c)(3) bonds in providing residential rental housing, exclusion from income of the value of employer-provided computers, and conforming and simplifying the Work Opportunity Tax Credit and the Welfare to Work Tax Credit.

MAKE PERMANENT THE TAX CUTS ENACTED IN 2001 AND 2003

Extend Through 2010 Certain Provisions of the 2003 Jobs and Growth Tax Cut

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually phased in the reduction in individual income tax rates and other tax benefits for individuals and families. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) accelerated implementation of the major EGTRRA provisions, but some provisions (described below) were accelerated only for 2003 and 2004. Beginning in 2005, these provisions will revert to the lower levels specified by EGTRRA's phase-in schedule.

Child Tax Credit. EGTRRA increased the child tax credit from $500 to $1,000 over a period of ten years. The credit was increased to $600 for 2001 through 2004, $700 for 2005 through 2008, $800 for 2009, and $1,000 for 2010. JGTRRA increased the child tax credit to $1,000 in 2003 and 2004. The credit will revert to $700 in 2005 and phase-up to $1,000 by 2010.

10-Percent Rate Bracket. EGTRRA created a 10-percent rate bracket. Effective in 2001, the 10-percent rate bracket applies to the first $6,000 of taxable income for single taxpayers, $10,000 of taxable income for heads of households, and $12,000 of taxable income for married couples filing joint returns. In 2008, the top of the 10-percent rate bracket will increase to $7,000 for single taxpayers and $14,000 for joint filers. In 2009 and 2010, these levels will be indexed for inflation. JGTRRA increased the thresholds to $7,000 for single taxpayers and $14,000 for joint taxpayers in 2003 and adjusted the thresholds for inflation in 2004 (to $7,150 for single filers, $10,200 for heads of households, and $14,300 for joint filers). In 2005, the thresholds for the 10-percent rate bracket will revert back to $6,000 for single filers, $10,000 for heads of households, and $12,000 for joint filers,

Standard Deduction for Married Couples. Over a five-year period beginning in 2005, EGTRRA increased the standard deduction for married couples filing joint returns to double the standard deduction for single filers. The standard deduction for joint filers was increased from 167 percent of the standard deduction for single filers to 174 percent in 2005, 184 percent in 2006, 187 percent in 2007, 190 percent in 2008, and 200 percent in 2009 and 2010. JGTRRA increased the standard deduction for joint filers to 200 percent of the standard deduction for single filers in 2003 and 2004. In 2005, the standard deduction for joint filers will revert to the level specified in EGTRRA (174 percent of the standard deduction for single filers).

15-Percent Rate Bracket for Married Couples. Over a four-year period beginning in 2004, EGTRRA increased the width of the 15-percent rate bracket for joint filers to twice the width for single filers. The top of the 15-percent rate bracket for joint filers was increased from 167 percent of the corresponding amount for single filers to 180 percent in 2005, 187 percent in 2006, 193 percent in 2007, and 200 percent in 2008, 2009, and 2010. JGTRRA increased the width of the 15-percent rate bracket for joint filers to twice the width for single filers in 2003 and 2004. In 2005, the top of the 15-percent rate bracket will revert to the level specified in EGTRRA (180 percent of the amount for single filers).

Reasons for Change

Last year, the Administration worked with Congress to enact tax relief to provide additional support for the economic recovery and promote long-term growth. The quick passage of JGTRRA meant that millions of taxpayers began to receive tax relief by July. Paychecks increased because withholding tables were adjusted immediately following the enactment of JGTRRA to reflect the lower tax rates and the expanded 10- and 15-percent tax rate brackets. Beginning in July, 24 million taxpayers with children received checks containing an increase in the child tax credit (of up to $400 per qualifying child).

Continuation of this tax relief is needed to ensure sustained strong economic growth in the future.

Proposal

The provisions of JGTRRA that revert to their EGTRRA levels on December 31, 2004 would be extended through 2010.

(As described in a later section, the Administration is also proposing to permanently extend the provisions of EGTRRA and JGTRRA that sunset.)

Revenue Estimate[1]

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-2009	2005-2014
($ in millions)							
0	-11,489	-25,810	-23,472	-18,956	-15,640	-95,367	-106,436

[1] The estimate includes both receipt and outlay effects. The outlay effect is $4,265 million for 2006, $4,131 million for 2007, $4,003 million for 2008, $3,936 million for 2009, $4,568 million for 2010, $16,335 million for 2005-2009 and $18,906 million for 2005-2014.

Permanently Extend Certain Provisions of the 2001 Tax Cut and the 2003 Jobs and Growth Tax Cut

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, reduced marriage penalties, eliminated the phase-out of personal exemptions and the limitation on certain itemized deductions for higher-income taxpayers, provided additional incentives for education, increased IRA and pension incentives, provided relief from the alternative minimum tax (AMT), and eliminated the estate tax. These and several other provisions of EGTRRA sunset on December 31, 2010.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the amount of qualifying property that can be expensed in the year of purchase rather than being depreciated and lowered the tax rates on qualifying dividends and on capital gains. The liberalized expensing provision sunsets on December 31, 2005. The dividend and capital gains provisions sunset on December 31, 2008.

Reasons for Change

The tax relief and incentives to work, save, and invest provided by EGTRRA and JGTRRA 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 plan for periods far beyond the scheduled sunset dates of the EGTRRA and JGTRRA provisions 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 and JGTRRA.

Proposal

The provisions of EGTRRA that sunset on December 31, 2010 would be permanently extended. The provisions of JGTRRA that sunset on December 31, 2005 and December 31, 2008 would be permanently extended.

Revenue Estimate[2]

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-2009	2005-2014
($ in millions)							
0	-287	-4,475	-6,980	-10,729	-30,124	-52,595	-883,312

[2] The estimate includes both receipt and outlay effects. There is no outlay effect for fiscal years 2005-2009. The outlay effect is $34,579 million for 2005-2014.

TAX INCENTIVES

Simplify and Encourage Saving

EXPAND TAX-FREE SAVINGS OPPORTUNITIES

Current Law

Current law provides multiple tax-preferred individual savings accounts to encourage savings for retirement, education, and health expenses. The accounts have overlapping goals but are subject to different sets of rules regulating eligibility, contribution limits, tax treatment, and withdrawal restrictions. 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. Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs) are both intended to encourage saving for education, but each is subject to different rules. Archer Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs) are intended to encourage saving for medical expenses.

Individual Retirement Accounts: 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 2004, the deduction is phased out for single and head-of-household filers with modified-AGI[3] between $45,000 and $55,000 (increasing to $50,000 to $60,000 in 2005), for married filing jointly filers with modified-AGI between $65,000 and $75,000 (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

[3] 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.

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 distributions from Roth IRAs 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 earnings or $3,000 for 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.

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 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.

Coverdell Education Savings Accounts: Taxpayers may elect to contribute up to $2,000 per year to a Coverdell Education Savings Account (ESA) for beneficiaries under age 18. The contribution limit is phased out for single filers with modified-AGI between $95,000 and $110,000 and for joint filers with modified-AGI between $150,000 and $160,000. Contributions are not deductible, but earnings on contributions accumulate tax-free. Distributions are excludable from gross income to the extent they do not exceed qualified education expenses that are incurred during the year the distributions are made and that are not used to claim another tax benefit (such as an education tax credit or a tax-free distribution from a qualified tuition program). The earnings portion of a distribution not used to cover qualified education expenses is includible in the gross income of the beneficiary and is generally subject to an additional 10 percent tax.

Except in the case of a special needs beneficiary, when a beneficiary reaches age 30, the account balance is deemed to have been distributed for nonqualified purposes. However, prior to the beneficiary reaching age 30, tax-free (and penalty-free) rollovers of account balances may be made to an ESA benefiting another family member.

Section 529 Qualified Tuition Programs: Contributions to a QTP are not deductible from income for federal tax purposes, but earnings on contributions accumulate tax-free. Taxpayers may exclude from gross income amounts distributed from a QTP and used for qualified higher education expenses, so long as the distribution is not used for the same educational expenses for which another tax benefit (such as an education tax credit or a tax-free distribution from an ESA) is claimed. Nonqualified distributions are subject to an additional tax. A change in the designated beneficiary of an account is not treated as a distribution, and therefore is not subject to income tax, if the new beneficiary is a member of the family of the prior beneficiary. Neither contributors nor beneficiaries may direct the investment of the account.

There is no specific dollar cap on annual contributions to a QTP. In addition, there is no limit on contributions to a QTP account based on the contributor's income, contributions are allowed at any time during the beneficiary's lifetime, and the account can remain open after the beneficiary reaches age 30. However, a QTP must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

Some states allow contributions to be excluded from income for state income tax purposes.

Health Savings Accounts: Individuals who are covered by a qualifying high deductible health plan and not covered by any non-high deductible health plan other than certain permitted or disregarded coverage may contribute to a health savings account (HSA) that can be used to reimburse the individuals' and their dependents' health expenses. Employers may also make contributions to employees' HSAs. The high deductible health plan may be provided by an employer or purchased in the individual insurance market. Individuals who are eligible for Medicare or to be claimed as a dependent on someone else's return may not contribute to an HSA. Contributions to HSAs are deductible and qualified distributions are excluded from gross income. Nonqualified distributions are subject to income tax and, if taken prior to age 65, an additional 10 percent tax.

Archer Medical Savings Accounts: Self-employed individuals and individuals employed by small employers maintaining a high deductible health plan (defined more restrictively than under the HSA) are allowed to accumulate funds in an Archer Medical Savings Account (MSA) 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 not covered by any non-high deductible health plan). Although individuals with MSAs can continue to contribute to them as long as they are with an MSA participating employer, no new MSAs are permitted after the end of 2003 except with respect to individuals being hired after 2003 by an MSA-participating employer. Contributions to MSAs are deductible and qualified distributions are excluded from gross income. Nonqualified distributions are subject to income tax and, if taken prior to age 65, an additional 15 percent tax.

Reasons for Change

The plethora of individual savings accounts, each subject to different rules regarding eligibility, contributions, tax treatment, and withdrawal, creates complexity and redundancy in the Code.

Taxpayers must determine their eligibility for each account separately and then must decide which plan or plans are best for them given their circumstances. Furthermore, as their circumstances change over time, taxpayers must continually re-evaluate their eligibility for each plan and which best meets their needs. The current list of non-retirement exceptions within IRAs weakens the focus on retirement saving, and the IRA exceptions and special purpose savings vehicles place 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. Consolidating the three types of IRAs under current law into one account dedicated solely to retirement, and creating a new account that could be used to save for any reason would simplify the taxpayer's decision-making process while further encouraging savings.

Savings will be further simplified and encouraged by administrative changes to the tax filing process that will allow taxpayers to direct that their tax refunds be directly deposited into more than one account. Consequently, taxpayers will be able, for example, to direct that a portion of their tax refunds be deposited into a Lifetime Savings Account or Retirement Savings Account described below. Simplifying the rules, making savings opportunities universally available, and making it easier for people to set money aside through direct deposit will complement the Administration's commitment to programs focusing on financial education and, specifically, retirement planning.

Proposal

The proposal would consolidate the three types of current law IRAs into a single account: a Retirement Savings Account (RSA). RSAs would be dedicated solely to retirement savings; other withdrawals would be subject to tax and penalty as described below. Instead of a list of exceptions for penalty-free early withdrawals, a new account, a Lifetime Savings Account (LSA) would be created that could be used for savings for any purpose, including augmenting retirement savings, health care, covering emergencies, and education.

Individuals could contribute up to $5,000 per year (or earnings includible in gross income, if less) to their RSA. As under current law IRAs, 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 $10,000. 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 a 10 percent 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. Married individuals could roll amounts from their RSA over to their spouses' RSA.

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, 2006, could include the conversion amount in income ratably over 4 years. Conversions made on or after January 1, 2006, 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).

Amounts converted to an RSA from a traditional IRA or from an Employer Retirement Savings Account (ERSA) would be subject to a 5-year holding period. Distributions attributable to a conversion from a traditional IRA or ERSA (other than amounts attributable to a Roth-type account in an ERSA) prior to the end of the 5-year period starting with the year the conversion was made or, if earlier, the date on which the individual turns 58, becomes disabled, or dies would be subject to an additional 10 percent early distribution tax on the entire amount. The 5-year period is separately determined for each conversion contribution. To determine the amount attributable to a conversion, a distribution is treated as made in the following order: regular contributions; conversion contributions (on a first-in-first-out basis); earnings. To the extent a distribution is treated as made for a conversion contribution, it is treated as made first from the portion, if any, that was required to be included in gross income because of the conversion.

Individuals could contribute up to $5,000 per year to their LSA, regardless of wage income. No income limits would apply to LSA contributions. Contributions would have to be in cash. The time period for which the contribution limit applies is the calendar year. 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 $5,000 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 $5,000. The LSA contribution limit would be indexed for inflation.

Control over an account in a minor's name would be exercised exclusively for the benefit of the minor, until the minor reached the age of majority (determined under applicable state law), by the minor's parent or legal guardian acting in that capacity. Married individuals could roll amounts from their LSAs over to their spouses' LSAs.

Taxpayers would be able to convert balances in Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs) to LSA balances. All conversions must be made before January 1, 2006, and would be subject to the following limitations. An amount can be rolled into an individual's LSA from a QTP only if that individual was the beneficiary of the QTP or ESA as of December 31, 2003. The amount that can be rolled over to an LSA from an ESA is limited to the sum of the amount in the accounts as of December 31, 2003, plus any contributions to and earnings on the accounts in 2004. The amount that can be rolled over to any LSA from a QTP is limited to the sum of (i) the lesser of $50,000 or the amount in the QTP as of December 31, 2003, plus (ii) any contributions and earnings to the QTP during 2004. Total rollovers to an individual's LSA attributable to 2004 contributions to the individual's ESAs and QTPs cannot exceed $5,000 (plus any earnings on those contributions).

QTPs would continue to exist as separate types of accounts, but could be offered inside an LSA. For example, State agencies that administer QTPs could offer LSAs with the same investment options available under the QTP. The plan administrator would be freed from the additional reporting requirements of a QTP for investments in an LSA, but investors would be subject to the annual LSA contribution limit. Distributions for purposes other than education would not be subject to federal income-tax or penalties. However, States would be free to provide State tax incentives, and administrators would be free to provide investment incentives, for savings used for educational purposes.

The Saver's Credit would apply to contributions to an RSA but would not apply to contributions to an LSA.

Both LSAs and RSAs would become effective beginning on January 1, 2005.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-2009	2005-2014
($ in millions)							
0	3,949	8,192	5,488	2,798	685	21,112	5,558

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.

Contribution Limits. The total annual contribution to a participant's account may not exceed the lesser of $41,000 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 non-highly-compensated employees' (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 percent or less; two percentage points over the NHCEs' ACP if the NHCEs' ACP is between 2 percent and 8 percent; or 125 percent of the NHCEs' ACP if the NHCEs' ACP is 8 percent 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 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, 20 percent of the benefit is vested after three years of service and an additional 20 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 20 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"). 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 $13,000 in 2004 (increasing to $15,000 by 2006). Participants aged 50 or over may make additional "catch-up" deferrals of up to $3,000 (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 $9,000 in 2004 (increasing to $10,000 in 2005). SIMPLE participants aged 50 or over may make additional "catch-up" deferrals of up to $1,500 (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.[4]

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 $13,000 limit that applies to employee pre-tax deferrals.

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

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

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.

403(b) plans: 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.[5] 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 $13,000 in 2004 (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 $3,000 (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, 2004.

[5] 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.

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 $13,000 annually (increasing to $15,000 by 2006), with employees aged 50 and older able to defer an additional $3,000 (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 $41,000. The 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, 2005, with a special transition for collectively bargained plans and plans sponsored by state and local governments.

Special Rule for Small Employers. Employers that had 10 or fewer employees making at least $5,000 during the prior year would be able to fund an ERSA by contributing to a custodial account, similar to a current-law IRA, provided the employer's contributions satisfy the design-based ERSA safe harbor described below. This custodial account would provide annual reporting relief for small employers as well as relief from most of the ERISA fiduciary rules under circumstances similar to the fiduciary relief currently provided to sponsors of SIMPLE IRAs.

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 percent of NHCEs' percentage if the NHCEs' average contribution percentage were 6 percent or less. In cases in which the NHCEs' average contribution percentage exceeded 6 percent, 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 increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions 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 an 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, 2004 (changed from after December 31, 2005, under current law).

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-214	-318	-337	-358	-380	-1,607	-11,763

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 in savings or investments, 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 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 2006. 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-134	-286	-326	-300	-255	-1,301	-1,380

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, individuals are allowed to accumulate funds in a health savings account (HSA) or in more limited circumstances in a medical savings account (Archer 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

According to some estimates, more than 43 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 HSA or an Archer 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, 2005, 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, 2004, and would be available in advance beginning July 1, 2006.

Revenue Estimate[6]

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-106	-5,177	-6,100	-7,242	-7,765	-26,390	-70,055

[6] The estimate includes both receipt and outlay effects. The outlay effects are $82 million for 2005, $3,760 million for 2006, $5,041 million for 2007, $6,388 million for 2008, $7,133 million for 2009, $22,404 million for 2005-2009, and $65,355 million for 2005-2014.

PROVIDE AN ABOVE-THE-LINE DEDUCTION FOR HIGH DEDUCTIBLE INSURANCE PREMIUMS

Current Law

Individuals who are covered by a qualifying high deductible health plan and not covered by any non-high deductible health plan other than certain permitted or disregarded coverage may contribute to a health savings account (HSA) that can be used to reimburse the individuals' and their dependents' health expenses. Employers may also make contributions to an individual's HSA. The high deductible health plan may be provided by an employer or purchased in the individual insurance market. Individuals who are eligible for Medicare or to be claimed as a dependent on someone else's return may not contribute to an HSA.

Individuals who purchase health insurance in the individual market may claim an itemized deduction for the premiums only to the extent that the premiums, when combined with other un-reimbursed medical care expenses, exceed 7.5 percent of AGI. Self-employed individuals are entitled to deduct (for purposes of federal income tax but not for purposes of the self-employment tax) the full amount of their health insurance coverage, whether or not they itemize deductions. Employer contributions for health insurance generally are excluded from gross income for income and employment tax purposes. Reimbursements made to an individual from health 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

Allowing all individuals to deduct the cost of high deductible health plans will encourage the use of those plans. Providing a deduction for the premium "above-the-line" will generally level the playing field for a segment of the population that does not have employer-sponsored coverage and encourage cost consciousness in the purchase of health care through greater reliance on high deductible health plans.

Proposal

Individuals who contribute to an HSA because they are covered under high deductible health insurance in the individual insurance market would be allowed a deduction in the amount of the premium in determining AGI (i.e, whether or not the person itemizes deductions). Similar to HSA rules, an individual would not qualify for the deduction if, in addition to the high deductible plan for which the deduction is claimed, he or she is covered by other health insurance, except for health insurance that provides only certain benefits. Individuals covered by employer plans or public plans or otherwise not eligible to contribute to an HSA would not qualify for the deduction.

The deduction would be available for tax years beginning after December 31, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-173	-1,764	-2,014	-2,292	-2,501	-8,744	-24,775

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 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. The deduction only applies to qualified long-term care insurance, which is required to satisfy certain standards set forth in the models published by the National Association of Insurance Commissioners (NAIC).

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 threshold that applies 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, the Secretary of the Treasury would be authorized to require qualified long-term care insurance

policies to meet consumer protection standards for quality coverage, for example, to reflect changes in the NAIC model standards.

The deduction would be effective for taxable years beginning on or after January 1, 2005, but would be phased in so that 25 percent of the premium would be deductible for 2005, 35 percent for 2006, 65 percent for 2007, and 100 percent for 2008 and thereafter.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-68	-489	-805	-1,572	-2,435	-5,369	-21,428

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,[7] (2) receive over half of his or her support from the taxpayer,[8] (3) not have gross income in excess of the exemption amount,[9] (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 2004, the amount of the exemption is $3,100. 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 ($142,700 for single filers, $214,050 for joint filers, $178,350 for heads of households, and $107,025 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 his or her adult children who choose to care for the parent 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 homes 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

A taxpayer 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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[7] Specified relatives include the taxpayer's sons, daughters, grandchildren, siblings, parents, aunts, uncles, nieces and nephews.

[8] 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.

[9] 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.[10] 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, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-71	-460	-398	-398	-415	-1,742	-3,759

[10] 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 (orphan drug credit). 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 credit for increasing research under section 41 of the Internal Revenue Code.

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 the 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 the 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 the 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 if the drug receives FDA designation as a potential treatment for a rare disease or condition before the due date (including extensions) for filing the tax return for the year in which the FDA application was filed.

The proposal would be effective for qualified expenses incurred after December 31, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
-*	-*	-*	-*	-*	-*	-1	-2

* less than .5 million.

CLARIFY THE HEALTH COVERAGE TAX CREDIT

Current Law

The Health Coverage Tax Credit (HCTC) was created under the Trade Adjustment Assistance (TAA) Reform Act of 2002 for the purchase of qualified health insurance. The HCTC is refundable and equal to 65 percent of the cost of qualified health insurance paid by eligible individuals, including certain recipients of the TAA or Alternative TAA (ATAA) benefits and certain individuals between the ages of 55 and 64 who are receiving pension benefits from the Pension Benefit Guaranty Corporation (PBGC). Individuals can claim the HCTC as part of the tax-filing process or through an advance payment program at the time qualified insurance is purchased.

Reasons for Change

The statute is unclear on a number of issues that need to be clarified in order to facilitate the administration of the HCTC. The proposal would clarify eligibility of several groups of PBGC pension recipients, the status of the U.S. possessions and territories to elect a state-based coverage option, the application of the confidentiality and disclosure rules to the administration of the advance payment program, and the qualification of state continuation coverage provided under a state law. In addition, the proposal would reduce the complexity in administering eligibility exclusion under "other specified coverage."

Proposal

The Administration proposes a number of modifications to the current law. First, the proposal would clarify that individuals who elect to receive one-time lump sum payments from the PBGC and certain alternative PBGC payees would be eligible for the HCTC. Second, for purposes of the state-based coverage rules, the proposal would deem the Commonwealths of Puerto Rico and the Northern Mariana Islands as well as American Samoa, Guam, and the U.S. Virgin Islands to be states. Third, the proposal would clarify that providers of health insurance could include employers and administrators of health plans and would allow disclosure of certain information necessary to carry out the advance payment program to providers of health insurance or their contractors. Fourth, the proposal would clarify that state continuation coverage provided under a state law would automatically qualify as "qualified health insurance," as federally mandated COBRA continuation coverage, without meeting the requirements relating to state-based qualified coverage. Finally, the proposal would apply the same list of "other specified coverage" to all eligible individuals by changing the definition of "other specified coverage" for "eligible ATAA recipients" to conform to the definition applied to other eligible individuals.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
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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, 2003. 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 2004.[11] 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-1,248	-1,103	-1,111	-1,144	-1,173	-5,779	-12,036

[11] 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 ($142,700 for most filers in 2004).

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, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
-68	-450	-341	-327	-330	-329	-1,777	-3,498

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, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-42	-87	-96	-106	-116	-447	-1,224

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, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-133	-83	-84	-86	-90	-476	-1,009

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, 2003, regardless of when the trust was created.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-8	-5	-6	-6	-6	-31	-68

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 deprives 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 would allow 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, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-21	-13	-15	-18	-21	-88	-239

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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-8	-10	-11	-10	-10	-49	-94

REPEAL CERTAIN 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-5	-6	-12	-18	-25	-66	-299

Strengthen Education

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 2002 and 2003, taxpayers who were K-12 teachers and certain other school personnel in a school for at least 900 hours during a school year were allowed to deduct, whether or not they itemize, 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 2003 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
-23	-229	-240	-249	-260	-263	-1,241	-2,611

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, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-27	-45	-43	-48	-55	-218	-668

[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 2004, the aggregate first-year credit authority allocated to each State will be the greater of $2.075 million or $1.80 per capita. This limit is indexed annually. 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 2005. 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 2005. The Treasury Department would have the authority to promulgate necessary reporting requirements.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-7	-81	-327	-776	-1,352	-2,543	-16,409

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 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
-178	-243	-212	-201	-191	-181	-1,028	-1,858

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, the 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, 2005 and before January 1, 2008.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-45	-88	-101	-58	0	-292	-292

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 2003. 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 three years to facilities placed in service before January 1, 2007. 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, 2004. Electricity produced at such facilities from newly eligible sources would be eligible for the credit only from January 1, 2004, through December 31, 2008. 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, 2004, through December 31, 2006. 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-401	-337	-305	-278	-139	-1,460	-2,175

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, 2003, and before January 1, 2007, and to photovoltaic systems placed in service after December 31, 2003, and before January 1, 2009.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-12	-11	-17	-23	-10	-73	-73

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, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-193	-147	-154	-162	-169	-825	-1,767

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 67 percent of U.S. oil consumption. Cars, sport utility vehicles, light trucks, and minivans alone account for 42 percent of U.S. oil consumption, about 20 to 40 percent of all urban smog-forming emissions, and 16 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, 2003, and before January 1, 2009. 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) Credit for qualified fuel cell vehicles. A credit of up to $8,000 would be available for the purchase of new qualified fuel cell vehicles after December 31, 2003, and before January 1, 2013. 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.

The percentage of maximum available power provided by the rechargeable energy storage system 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-79	-223	-376	-556	-542	-1,776	-2,211

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 2002 calendar year was 2.1169, and the inflation-adjusted amount of the credit for that year was $6.35 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 2002, the inflation adjusted threshold for onset of the phaseout was $49.75 ($23.50 x 2.1169) and the average wellhead price for that year was $22.51.

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, 2003, and before January 1, 2012, and is sold (or used to produce electricity that is sold) before January 1, 2012. 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, 2004, 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, 2003, 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, 2003, is treated as produced from the portion of the facility placed in service after that date.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-34	-67	-91	-104	-117	-413	-737

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. 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, 2003, but before January 1, 2009.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-154	-107	-64	-62	-13	-400	-349

EXTEND 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
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PERMIT ELECTRIC UTILITIES TO DEFER GAIN FROM SALES OF ELECTRIC TRANSMISSION PROPERTY

Current Law

Gain on the sale of business assets is subject to current income tax unless a special rule provides for nonrecognition or deferral of the gain.

Reasons for Change

To improve transmission management and facilitate the formation of competitive energy markets, federal and State energy regulators are calling for vertically integrated utilities to place their transmission assets under the ownership or control of independent transmission providers (or other similarly approved operators). The current tax on gain from the sale of business assets may, however, inhibit the dispositions that energy regulators are attempting to encourage. A limited deferral of the tax on gain from these dispositions, available only to the extent proceeds of the disposition are reinvested in utility property, would facilitate electric deregulation and encourage investment in modernization of the country's energy infrastructure.

Proposal

Electric utilities would be permitted to defer the gain from sales of electric transmission property (or an ownership interest in an entity providing electric transmission services) to an independent transmission company. For this purpose, an independent transmission company would be defined as (1) any FERC-approved regional transmission organization, independent system operator, or independent transmission company; (2) any person that FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a market participant and whose transmission facilities are placed under the operational control of a FERC-approved regional transmission organization, independent system operator, or independent transmission company; and (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas (i) any entity approved by that Commission as consistent with Texas law regarding an independent transmission organization or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of such an entity. A taxpayer electing deferral under the proposal would recognize the gain ratably over the eight-year period beginning with the year of sale. Deferral would be available only to the extent the taxpayer (or an affiliate) reinvests the amount received for the transmission property in other electric or gas utility property during the period ending four years after the end of the taxable year in which the disposition occurs. The period for assessing a deficiency with respect to the deferred gain of an electing taxpayer would not expire until three years after the IRS is notified of the reinvestment or of the taxpayer's intent not to reinvest. The proposal would apply to sales or other dispositions occurring after the date of enactment and before January 1, 2007.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-11	-475	-615	-532	-227	100	-1,749	361

MODIFY TAX TREATMENT OF CERTAIN INCOME OF ELECTRIC COOPERATIVES

Current law

Mutual or cooperative electric companies (electric cooperatives) are generally exempt from federal income tax if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses (the 85-percent test). Taxable electric cooperatives may exclude from taxable income certain profits rebated to patrons.

Reasons for Change

Competitive electricity markets will benefit consumers and enhance economic growth. Certain rules governing the taxation of electric cooperatives should be modified to facilitate participation by electric cooperatives in electric industry restructuring.

Proposal

Income of electric cooperatives from the following activities would be excluded from the 85-percent test: (1) providing open access transmission service under a tariff filed with the Federal Energy Regulatory Commission (FERC) (or, if applicable, the Public Utility Commission of Texas) or an independent transmission provider agreement approved or accepted by FERC (or, if applicable, the Public Utility Commission of Texas); (2) providing open access distribution service (i) to deliver electricity to end-users served by distribution facilities not owned by the cooperative or any of its members, or (ii) to deliver to third parties electricity generated by a facility that is not owned or leased by the cooperative or any of its members and is directly connected to distribution facilities owned by the cooperative or any of its members; (3) certain transfers into (and distributions and earnings from) a trust, fund or instrument established to pay nuclear decommissioning costs; and (4) certain voluntary exchanges or involuntary conversions of property related to generating, transmitting, distributing or selling electric energy. The Administration also proposes that income from sales of electric energy to non-members be treated as qualifying member income (and, in the case of certain taxable electric cooperatives, excluded from taxable income whether or not profits are rebated to patrons) to the extent such sales do not exceed the cooperative's load losses during a specified ten-year recovery period.

The proposal would be effective for taxable years beginning after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-14	-20	-21	-22	-23	-100	-235

SIMPLIFY THE TAX LAWS FOR FAMILIES

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.[13]

Second, the individual also must receive more than half of his or her support from the taxpayer.[14] 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 ($3,100 in 2004). 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 generally is 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

[13] 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.

[14] 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 also may 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 also may 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 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 generally must reside with the taxpayer in the same principal 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 2005, there will be over 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 2005

Child-Related Tax Benefit	Number of Returns (millions)
Dependent Exemption	53.8
With Child	50.3
Head of Household Filing Status	24.4
With Child	22.2
Child Tax Credit	32.0
Child and Dependent Care Tax Credit	6.4
Earned Income Tax Credit	21.6
With Child	17.7

In many cases, taxpayers will claim more than one of these benefits. For example, 32.0 million taxpayers will claim both child dependent exemptions and the child tax credit, 16.5 million taxpayers will claim both child dependent exemptions and the EITC, and 10.7 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 also may 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.[15] 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

[15] 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.

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.[16] 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 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

[16] 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.

number that is valid for employment in the United States (that is, EITC qualifying children 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, 2004.

Revenue Estimate[17]

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	-38	-70	-65	-56	-46	-275	-475

[17] The estimate includes both receipt and outlay effects. The outlay effect is $36 million for 2006, $36 million for 2007, $36 million for 2008, $37 million for 2009, $145 million for 2005-2009 and $333 million for 2005-2014.

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
Brothers, sisters, nieces, nephews	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 BENEFITS

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 2004, the separate limits on qualified adoption expenses for the credit and the exclusion are $10,390. 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 $10,390 credit or exclusion even if adoption expenses are less than that amount. Taxpayers may carry forward unused credit amounts for up to five years. If modified adjusted gross income exceeds $155,860 (in 2004), 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 for the adoption of a child with special needs, only for qualified expenses they actually incur, 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, as a result of the Administration's separate proposal to permanently extend all provisions of EGTRRA, 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.

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 2004, has $10,390 of adoption expenses eligible for the tax credit and that is in the phase-out range has its marginal tax rate increased by 26.0 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, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-4	-39	-40	-42	-43	-168	-411

ELIMINATE HOUSEHOLD MAINTENANCE TEST FOR HEAD-OF-HOUSEHOLD FILING STATUS

Current Law

Taxpayers who qualify as heads of households may claim a standard deduction that is equal to 147 percent of the standard deduction claimed by single filers. Their income is taxed under a separate rate structure that is more generous than the rate structure that applies to single filers.

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 taxable year the principal place of abode for (1) an unmarried son, daughter, stepchild, or a descendant of the taxpayer's son or daughter; (2) a married son, daughter, stepchild, or a descendant of the taxpayer's son or daughter, whom the taxpayer can claim as a dependent; or (3) a relative whom the taxpayer can claim as a dependent. An unmarried taxpayer also may claim head of household filing status if he or she maintains a separate household for a dependent parent for the tax year.

Taxpayers who qualify as surviving spouses may use the standard deduction and rate brackets that are applicable to married couples filing jointly, which are more generous than the standard deduction and rate brackets that apply to single filers.

A taxpayer may qualify as a surviving spouse if his or her spouse died during either of the two years immediately preceding the current taxable year. In addition, the taxpayer must maintain as his or her home the household that constitutes for the taxable year the principal place of abode for a dependent who is the taxpayer's son, daughter, or stepchild.

Reasons for Change

In 2005, 24.5 million taxpayers will claim either head of household or surviving spouse filing status on their tax returns. To qualify for either filing status, these taxpayers will have to demonstrate that they provide over half the cost of maintaining the home in which they reside. (An unmarried taxpayer also can qualify as a head of household if he or she provides over half the cost of maintaining the home in which the taxpayer's dependent parent resides.) This household maintenance test is difficult to understand and administer.

First, taxpayers must read a separate page of instructions in Publication 501 to determine if they qualify as a head of household. Then, they must complete an eleven-line worksheet to determine if they provide over half the cost of maintaining their home. Taxpayers also must compile and retain records to prove they meet the household maintenance test.

Second, taxpayers can easily be confused by the subtle distinctions between the household maintenance test and the similar, but not identical, support test used to determine whether someone is a dependent (a separate 22-line worksheet in Publication 501). For example, mortgage interest expenses and property taxes are counted toward the cost of maintaining a household, but the taxpayer is instructed to factor in the "fair rental value of a home" toward support. To compute household maintenance, taxpayers must measure the cost of food

consumed on the premises. But for the support test, the taxpayer must include the cost of all food, regardless of where it is eaten.

Third, the IRS does not receive independent information to verify that taxpayers have met the household maintenance test. As a consequence, the IRS cannot verify that an unmarried taxpayer is a head of household in the absence of a burdensome audit.

Proposal

An unmarried taxpayer would no longer be required to meet a household maintenance test in order to claim head of household filing status. An unmarried taxpayer would be considered a head of household if he or she resides with a qualifying child or a related dependent for more than half the year. An unmarried taxpayer also may qualify as a head of household if he or she claims a parent as a dependent, regardless of where the parent resides.

A special rule would apply to unmarried parents who reside together with their child for more than half the year. In this instance, only one parent would be allowed to claim head of household filing status. If both parents claim head of household filing status, only the taxpayer with the higher adjusted gross income (AGI) would be deemed eligible. For purposes of this rule, a child is defined as the taxpayer's son or daughter.

To qualify as a surviving spouse, a taxpayer would no longer have to meet a household maintenance test. A taxpayer would be considered a surviving spouse if his or her spouse died during either of the two years immediately preceding the current taxable year. In addition, the taxpayer must reside with his or her dependent child for over half the taxable year. For purposes of this provision, a child is defined as the taxpayer's son, daughter, or stepchild.

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

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-123	-297	-284	-285	-281	-1,270	-2,555

REDUCE COMPUTATIONAL COMPLEXITY OF REFUNDABLE CHILD TAX CREDIT

Current Law

An individual may claim a $1,000 tax credit for each qualifying child under the age of 17.[18] A qualifying child must be a citizen, national, or resident of the United States. The child tax credit is phased out for individuals with income over certain thresholds,[19] and is partially refundable.

Taxpayers may be eligible for a refundable amount (the additional child tax credit) equal to 10 percent of earned income in excess of $10,750.[20] Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income.[21]

Families with three or more children may determine the additional child tax credit using an alternative formula. A taxpayer can claim an additional child tax credit equal to the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit, if that amount is greater than the additional child tax credit based on the taxpayer's earned income in excess of $10,750.

Reasons for Change

The additional child tax credit is difficult to compute and unduly complicated. To compute the credit amount, low and moderate-income taxpayers must attach a separate form to their tax return. Many taxpayers with three or more children must compute the additional child tax credit twice to determine which formula yields the larger credit.

In addition, the eligibility criteria for the additional child tax credit differ from those used for the similar EITC. (About 75 percent of taxpayers who are eligible for the additional child tax credit also can claim the EITC.) Although both credits are based on earned income and the number of children in the family, they use different definitions of earned income and qualifying children. For example, when computing the additional child tax credit, taxpayers may count earned income only to the extent that it is included in taxable income; however, when computing the EITC, other types of income that are not included in computing taxable income are counted.

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[18] The amount of the child tax credit will be $700 in 2005, $800 in 2008, and $1,000 in 2010. The Administration is proposing that the child tax credit be increased to $1,000 in 2005.

[19] Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.

[20] The percentage is increased to 15 percent for calendar years 2005 and thereafter. The earned income threshold amount is indexed for inflation.

[21] For example, some ministers add parsonage allowances to self-employment income when computing the EITC, but such allowances are excluded from taxable income for purposes of the additional child tax credit.

Another example is that the additional child tax credit may be claimed by taxpayers who reside with children outside the United States, while the child-based EITC may be claimed only by taxpayers who reside with children in the United States.

Proposal

Eliminate Multiple Computations. Taxpayers with three or more children would no longer have the option to compute the additional child tax credit using an alternative formula that compares social security taxes paid to the amount of the EITC received. The additional child tax credit would be based solely on the formula that uses earned income, regardless of the number of children in a taxpayer's family.

Conform the Definition of Earned Income. The definition of earned income for purposes of the additional child tax credit would be conformed to that currently used for the EITC. Thus, earned income for both credits would equal the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. The proposal would eliminate the requirement that earned income be included in taxable income in order to be included in computing the additional child tax credit.

Require Taxpayers to Reside in the United States. The proposal would require taxpayers to reside with a child in the United States to claim the additional child tax credit. The principal place of abode for members of the U.S. Armed Forces would be treated as in the United States for any period the member is stationed outside the United States while serving on extended active duty. Extended active duty would include a call or order to such duty for a period in excess of 90 days.

The proposal would be effective for tax years beginning after December 31, 2004.

Revenue Estimate[22]

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	0	181	183	185	187	736	1,722

[22] The estimate includes both receipt and outlay effects. The outlay effect is -$181 million for 2006, -$183 million for 2007, -$185 million for 2008, -$187 million for 2009, -$736 million for 2005-2009 and -$1,701 million for 2005-2014.

SIMPLIFY EITC ELIGIBILITY REQUIREMENTS REGARDING FILING STATUS, PRESENCE OF CHILDREN, INVESTMENT INCOME AND WORK AND IMMIGRANT STATUS

Current Law

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

Filing Status: An unmarried individual can claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally cannot claim the EITC unless they file jointly. However, there is an exception for estranged spouses who meet three requirements. First, an estranged spouse must live apart from his or her spouse for the last six months of the year. Second, the estranged spouse must maintain a household that constitutes the principal place of abode for a dependent child for over half the year. Third, the estranged spouse must pay over half the cost of maintaining the home in which he or she resides with the child during the year. If the estranged spouse meets these conditions, he or she may file a tax return as a head of household and claim the EITC.

Presence of Qualifying Children: A taxpayer who resides with a qualifying child may be eligible for an EITC of up to $2,604 ($4,300 for two or more children). A taxpayer who does not reside with a qualifying child may be eligible for a smaller credit of up to $390. A taxpayer may claim the EITC for workers without children only if the taxpayer does not reside with a qualifying child.

To be considered an EITC qualifying child, a child must meet residency, relationship, and age tests. Even if the child meets the three qualifying child tests, the taxpayer may not be able to claim the EITC. For example, if more than one taxpayer lives with a qualifying child, only one of those taxpayers can claim the child for purposes of the EITC.[23] If a taxpayer lives with a qualifying child, but is not allowed to claim the child because the child is properly claimed by someone else, the taxpayer is not eligible for the EITC. Because the taxpayer resides with a qualifying child, he or she is ineligible for the EITC for workers without children.

A similar situation arises when a taxpayer resides with a qualifying child who does not have a valid social security number. The taxpayer is not eligible for the EITC for taxpayers with

[23] If more than one taxpayer claims the same qualifying child for purposes of the EITC, then only the claimant with the highest adjusted gross income (AGI) is deemed eligible. However, a 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 EITC.

children because the child lacks a valid social security number. The taxpayer also is ineligible for the EITC for workers without children because he or she lives with a qualifying child.

Investment Income: To qualify for the EITC, a taxpayer must meet an investment income test, in addition to two other tests for earned income and adjusted gross income.

A taxpayer cannot have disqualified investment income in excess of $2,650. Disqualified investment income includes interest (including tax-exempt interest), dividends, net capital gains, net income from rents or royalties, and net income from passive activities.

Work and Immigration Status: To claim the EITC, the taxpayer (including his or her spouse, if married) and qualifying child must have valid social security numbers. A social security number is considered invalid for EITC purposes if it was issued by the Social Security Administration *solely* to allow an individual to obtain federal benefits. Thus, an individual who is not authorized to work in the United States but who obtained a social security number in order to receive Medicaid or another federal benefit is not eligible for the EITC. However, an individual who is not authorized to work in the United States but who obtained a social security number for a reason other than to obtain federal benefits (e.g., a driver's license or for tax purposes prior to the creation of the ITIN) is eligible for the EITC.

The IRS may use math error authority to deny EITC claims when the taxpayer does not provide valid social security numbers.

Reason for Change

A recent IRS report found that between $8.5 and $9.9 billion of EITC claims (27 percent to 31.7 percent of total claims) were erroneously paid with respect to tax year 1999 returns. Many of these errors related to taxpayers who failed to meet eligibility criteria concerning family and income status. Simplifying the eligibility requirements for the EITC should help to reduce these erroneous claims.[24]

Some of these errors may have been caused by taxpayer confusion over unusual family situations and the complicated tax rules that were created to address these situations. For example, an individual who has separated from his or her spouse, but who cannot afford a lawyer to obtain a divorce or legal separation, is required to understand a complicated three-part test to determine his or her filing status under current law. Separated spouses may have to consult two IRS publications (Publication 596 on the EITC and Publication 501 on filing status) in order to determine if they are eligible for the EITC. They must compile and retain documentation showing that they provided over half the cost of maintaining the home in which they and their

[24] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contains several provisions that significantly simplified the EITC eligibility criteria and instructions. These provisions include a simplified tiebreaker test to resolve duplicate claims and conforming the definitions of earned income and adjusted gross income to those used elsewhere in the tax code. The proposal to adopt a uniform definition of qualifying child, included in the Budget, would further reduce the complexity of the EITC eligibility criteria. In addition to these simplification efforts, the IRS is implementing a new five-point initiative during the 2004 filing season, which seeks to better detect erroneous claims before refunds are paid.

children reside. In tax year 1999, nearly $1 billion of EITC overclaims were due solely to married taxpayers claiming single or head of household filing status when they should have filed as married-filing-separately. Many of these claims would not be erroneous if separated spouses were not required to document that they provide over half the cost of maintaining the household in which they reside with their children.

Other types of complicated family situations result in complicated tax rules. For example, if a child lives with her mother in her grandmother's home for over half the year, the child is a qualifying child of both her mother and grandmother. If the mother claims the child for the EITC, the grandmother is not eligible for the EITC for workers without children because she is still considered to have a qualifying child (her granddaughter). However, the grandmother may erroneously claim the childless EITC, not realizing that she is ineligible to claim the credit because she lives with her daughter and granddaughter. Taxpayers may be confused by the subtle difference between having a qualifying child one cannot claim for the EITC and having no qualifying child at all.

Efforts to target the EITC to specific populations also give rise to complexity. To determine if they are eligible for the EITC, low-income workers must meet three different income tests. The most complicated of these tests concerns investment income, including capital gains, properties sales, rents, and royalties. Most EITC claimants do not have income from any of these sources, but they have to read through 22 lines of complicated instructions in the Schedule EIC in order to learn that the disqualified investment income test does not affect their eligibility for the EITC. Those who think the disqualified investment income test applies to them must complete a 14-line worksheet in Publication 596.

The disqualified investment income test may have other undesirable effects, in addition to its effects on complexity. It may discourage saving by working families trying to move into the middle class. The disqualified investment income test contains a cliff, whereby an individual with $2,650 of investment income is qualified to receive an EITC of up to $4,300 while an individual with $2,651 of investment income would receive no EITC at all. The test favors some types of assets over others. For example, owning a home or car does not affect a taxpayer's eligibility for the EITC, but other forms of investments could generate income that would result in the denial of the EITC. Eliminating the disqualified investment income test would encourage both saving and an efficient allocation of resources.

In some cases, targeting provisions may be more complicated than they were intended to be. A provision of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (the "1996 Act") was intended to deny the EITC to any person (including his or her spouse and children) who is not authorized to work in the United States. Individuals may obtain a social security number if they are citizens or permanent residents or other persons authorized to work in the United State. Individuals not authorized to work in the United States may also obtain a social security number in order to receive certain federal benefits. In addition, until recently, it was possible for some individuals to receive social security numbers for themselves or their children for other reasons – e.g., to obtain a driver's license in some states or, before the adoption of ITINs, to file a tax return or claim certain tax benefits. As drafted, the 1996 Act denied the EITC to taxpayers who receive a social security number solely to receive federal benefits. The 1996

Act did not deny the EITC to individuals who are not authorized to work in the United States and who received social security numbers for reasons other than to obtain federal benefits. Thus, the statutory language in the 1996 Act did not have its intended effect. The disparate treatment of individuals with non-work-related social security numbers is confusing, inequitable, and difficult to administer. In tax year 1999, about $500 million of EITC overclaims were attributable to returns filed by taxpayers who did not provide valid social security numbers for themselves, their spouses, or their children. In most of these cases, the taxpayer was not eligible for the EITC for additional reasons. Typically, they failed to demonstrate that they resided with a child in the United States.

Proposal

Allow separated spouses to claim EITC. Married taxpayers who file separate returns would be allowed to claim the EITC if they live with a qualifying child for over half the year. They must also live apart from their spouse for the last six months of the tax year. However, they would not be required to provide over half the cost of maintaining the household in which they reside.

Simplify rules regarding presence of qualifying child. A taxpayer with a qualifying child who lives in an extended family would be eligible to claim the EITC for workers without children even if another member of the family claims the taxpayer's qualifying child. However, if unmarried parents reside together with their child, then one parent can claim the EITC for qualifying children, but neither can claim the EITC for workers without children.

Taxpayers would be eligible to receive the EITC for workers without children if their child does not have a valid social security number. As under current law, the taxpayer (and spouse, if married) must have a valid social security number.

Eliminate disqualified investment income test. The disqualified investment income test would be eliminated.

Clarify when a social security number is valid for EITC purposes. Both the taxpayer (including 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 are U.S. citizens, permanent residents, or have certain types of temporary visas that allow them to work in the United States).[25]

[25] Taxpayers who initially received a social security number for non-work reasons, but who subsequently became authorized to work in the United States (i.e., they became permanent residents or U.S. citizens), would be eligible to receive the EITC.

Revenue Estimate[26]

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	504	-167	-165	-151	-167	-146	-915

[26] The estimate includes both receipt and outlay effects. The outlay effects are -$440 million for 2005, $131 million for 2006, $130 million for 2007, $119 million for 2008, $134 million for 2009, $74 million for 2005-2009 and $643 million for 2005-2014.

SIMPLIFY THE TAXATION OF DEPENDENTS

Current Law

The standard deduction of taxpayers who may be claimed as dependents of another taxpayer is the lesser of: (1) the standard deduction for single taxpayers ($4,850 for 2004, indexed annually thereafter for the effects of inflation); or (2) the larger of $800 (for 2004) or the individual's earned income plus $250 (for 2004).

For minors under age 14 with taxable investment income, special rules (often called the "kiddie tax") apply. Only the first $800 (in 2004) of the child's taxable investment income over the standard deduction is taxed at the child's tax rate. Taxable investment income in excess of $800 is taxed as the marginal income of the parents (or guardian).[27] [28] In certain cases, the parents (or guardian) may elect to include the dependent's income on their own tax return.[29]

Reasons for Change

The current standard deduction for dependents requires dependents with earnings of $550 or more to file a tax return if their interest and dividend income exceeds $250. This necessitates the filing of a significant number of tax returns with very small amounts of tax liability. Eliminating such tax returns would benefit both taxpayers and the IRS.

The special "kiddie tax" provisions are extremely complex and lead to uncertainty about the tax rate that will apply to a minor child's investment income. In addition, the parental election option increases the number of required decisions as well as adding to the complexity and length of instructions and tax forms. This complexity may cause a misunderstanding of the rules and has caused considerable frustration among taxpayers. This, in turn, may discourage use of even the limited tax benefits of holding savings under the child's name permitted under current law.

Subsequent to enactment of the "kiddie tax," three tax provisions have been enacted that allow tax-free accumulation of savings for educational purposes: the exclusion of the interest on education savings bonds; Coverdell education savings accounts; and section 529 college savings

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[27] For a child with no earned income who uses the standard deduction, the first $800 of investment income is not subject to tax (because of the standard deduction), the next $800 is taxed at the child's tax rate (generally, 10 percent), and amounts above that are taxed as the marginal income of the parents or guardian.

[28] If there is more than one child under 14 with taxable investment income exceeding $800, the incremental tax from adding the total taxable investment income of all such children to the parents' taxable income is allocated among all affected children in proportion to each child's taxable investment income. (The tax on any capital gains is calculated through similar, but separate, incremental calculations.)

[29] If (1) the gross income of a dependent under age 14 is solely from interest, dividends, capital gains distributions, and Alaska Permanent Fund dividends, (2) if the total amount of the child's income is less than $8,000 (in 2004), and (3) no prepayments of tax (estimated tax payments or backup withholding) have been made for this income, then the parents (or guardian) may elect to include the dependent's income on their own tax return. (The parents' return can include the income of more than one eligible dependent.) The computations used generally result in the tax being the same as if a separate return were filed for the dependent, although interactions with certain income-based phaseouts, limitations, and floors may affect the tax liability on the dependent's (and parents') income.

or prepayment plans. It is anomalous to provide such benefits while imposing significantly higher taxes on families who choose to save for education without using these special provisions.

Proposal

The standard deduction for all dependents would be $800 (indexed) plus the amount of the dependent's earned income, but not to exceed the standard deduction for a non-dependent single filer.

For dependents under age 14, the first $2,500 (indexed after 2005) of taxable investment income and all earned income would be taxed at the child's own tax rate. Any taxable investment income above $2,500 would be taxed at the highest regular income tax rate (regardless of the parent's tax rate). Any dividends or capital gains included in taxable investment income above $2,500 would be taxed at the highest dividends or capital gains tax rates, respectively, generally applicable. The election to include the child's investment income on the parents' tax return would be eliminated.

These changes would be effective for taxable years beginning after December 31, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-11	-25	-20	-25	-43	-124	-498

CONSOLIDATE RULES FOR LIFETIME LEARNING CREDIT, HOPE CREDIT AND EDUCATION EXPENSE DEDUCTIONS, AND SIMPLIFY OTHER HIGHER EDUCATION PROVISIONS

Consolidate Higher Education Credits and Deductions

Current Law

A taxpayer may deduct up to $2,500 of interest on student loans. This deduction is phased out between $50,000 and $65,000 of modified adjusted gross income ("AGI") for single taxpayers ($100,000 and $130,000 for joint returns). The phase-out thresholds are indexed for inflation subject to a $5,000 rounding convention.

A taxpayer may deduct up to $4,000 of qualifying higher education expenses. Single taxpayers whose modified AGI does not exceed $65,000 ($130,000 for joint returns) may deduct up to $4,000 of qualified expenses. Taxpayers with modified AGI between $65,000 and $80,000 (between $130,000 and $160,000 for joint returns) may deduct up to $2,000 of qualified expenses. This provision was enacted on a temporary basis in 2001 and expires after 2005.

A taxpayer may claim one or both of the following nonrefundable tax credits for qualified tuition and fees for enrollment of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent in a postsecondary degree or certificate program. To be eligible for the Hope credit, the student must be enrolled on at least a half-time basis. The Hope Credit is equal to 100 percent of the first $1,000 of qualified expenses and 50 percent of the next $1,000 of qualified expenses, for a maximum credit of $1,500 per student. The Hope Credit is only available for the first two years of a student's postsecondary education.

A taxpayer may claim a nonrefundable lifetime learning credit for all postsecondary education, including graduate education and programs not leading to a degree or certificate. The credit is equal to 20 percent of up to $10,000 of qualified tuition and required fees paid during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. There is no limit on the number of years for which the lifetime learning credit may be claimed. The $10,000 amount is not indexed for inflation.

For calendar year 2004, the income phase-outs for the Hope credit and the lifetime learning credit begin at $42,000 of modified AGI ($85,000 for joint returns). The threshold amounts are indexed for inflation subject to a $1,000 rounding convention. In addition, the amount of the allowable Hope credit is indexed for inflation in future years (subject to a $100 rounding convention). Taxpayers may claim the Hope credit for more than one qualifying student. In contrast, the lifetime learning credit, is applied on a per-taxpayer, rather than a per-student, basis.

Reasons for Change

Taxpayers may be easily confused by the potential application of multiple provisions relating to higher education expenses. Taxpayers are likely to become confused by the per-student rules of the Hope credit and the per-taxpayer rules of the lifetime learning credit, or to be unaware that they can claim the Hope credit for one student and the lifetime learning credit for another. Some

taxpayers have to make detailed computations to determine which provision gives the best result for each student.

Proposal

Under the Administration's proposal, the lifetime learning credit would be revised to subsume the deductions for student loan interest and qualified higher education expenses by allowing the credit on a per-student basis and treating up to $2,500 of interest on student loans as a qualified expense. The temporary above-the-line deduction for higher education expenses and the deduction for student loan interest would be repealed. The beginning of the phase-out range would be raised to $50,000 ($100,000 for joint returns) and a new phase-out rule would be added that would reduce the otherwise allowed credits by 5 percent of the extent to which modified AGI exceeds the new limits. The phase-out rules for the Hope credit would be conformed to those of the revised lifetime learning credit.

The dollar limits of the revised lifetime learning credit and the Hope credit would be indexed for inflation after 2005 using a $100 rounding convention. The phase-out rules for the Hope credit and the lifetime learning credit would be indexed for inflation after 2005 using a $1,000 rounding convention.

Simplify the Definitions of a Qualifying Higher Educational Institution and Qualified Educational Expenses

Current Law

Seven provisions define a qualifying higher education institution to include institutions eligible to participate in federal student aid programs under Title IV of the Higher Education Act of 1965.[30] Four provisions use the broader section 170(b)(1)(A)(ii) definition, which includes "an organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."[31]

[30] These provisions are: (i) the Hope credit, (ii) the lifetime learning credit, (iii) the exclusion from gross income for distributions from Coverdell accounts, (iv) the exclusion from gross income for distributions from qualified tuition programs, (v) the exclusion from gross income for Savings Bond interest, (vi) the deduction for interest on educational loans, and (vii) the temporary above-the-line deduction for higher education expenses. The deduction for interest on educational loans also applies with respect to institutions "conducting an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility which offers postgraduate training."

[31] These provisions are: (i) the personal exemption for full time dependent children aged 19 through 23, (ii) the exclusion from gross income of scholarships and fellowships, (iii) the exclusion from gross income of qualified tuition reductions, and (iv) the exclusion from the gift tax of amounts paid as tuition to an educational institution. The personal exemption also covers students who are "pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii) or of a State or a political subdivision of a State."

Seven higher education provisions treat tuition and required fees as qualifying expenses.[32] Four of these seven provisions exclude tuition and required fees with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program.[33] Three of the seven provisions exclude non-academic fees.[34] Two additional provisions treat only tuition as a qualifying expense.[35]

Three higher education provisions treat books, supplies and equipment as qualifying expenses. Scholarship and fellowship income spent on books, supplies and equipment is treated as a qualifying expense (and therefore exempt from tax) if the books, supplies and equipment are required for courses of instruction. Distributions received from a Coverdell account or a qualified tuition program for books, supplies, and other equipment are treated as made for qualifying expenses (and therefore exempt from tax) if the books, supplies and equipment are required for enrollment or attendance. There is currently no limit on the amount that can be received tax-free for required books, supplies and equipment under these provisions. The remaining higher education provisions do not treat books, supplies and equipment as qualifying expenses.

A beneficiary of a Coverdell educational savings account or a qualified tuition program may receive distributions tax-free from the account or program for expenses for "special needs services in the case of a special needs beneficiary" which are incurred in connection with the enrollment or attendance of the beneficiary. "Special needs services" are not defined under current law.

Students who are enrolled at least half time can receive distributions tax-free from a Coverdell account or a qualified tuition program for room and board expenses. The amount that can be received tax-free, however, cannot exceed the greater of (i) the room and board amount included in the institution's cost of attendance for federal student aid purposes[36] or (ii) the actual invoiced amount for students residing in housing owned and operated by the institution.

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[32] The seven provisions are: (i) the exclusion from gross income or scholarships and fellowships, (ii) the Hope credit, (iii) the lifetime learning credit, (iv) the exclusion from gross income of distributions from Coverdell accounts, (v) the exclusion from gross income of distributions from qualified tuition plans, (vi) the temporary above-the-line deduction for higher education expenses, and (vii) the exclusion from gross income of Savings Bond interest.

[33] The four provisions are: (i) the Hope credit, (ii) the lifetime learning credit, (iii) the temporary above-the-line deduction for higher education expenses, and (iv) the exclusion from gross income for Savings Bond interest.

[34] The three provisions are (i) the Hope credit, (ii) the lifetime learning credit, (iii) the temporary above-the-line deduction for higher education expenses.

[35] The two provisions are: (i) the exclusion from gift tax and (ii) the exclusion from gross income for tuition reductions.

[36] The cost of attendance amounts are established separately by each institution. In addition, these amounts are widely available for student aid purposes and therefore easily accessible to taxpayers. See the following U.S. Department of Education web site for the cost of attendance data for individual institutions: http://www.nces.ed.gov/ipeds/cool.

Reasons for Change

Taxpayers may be easily confused by the different definitions of a qualifying higher education institution and by the different definitions of qualifying higher education expenses for tuition and fees, or for books, supplies and equipment. As a result, taxpayers may erroneously claim tax benefits or fail to claim tax benefits for which they are eligible.

The lack of defined limits on the amounts that can be received tax-free from scholarships and fellowships and for books, supplies and equipment causes numerous disputes between taxpayers and the IRS. It also provides opportunities for non-compliance because some taxpayers overstate these costs.

The lack of a definition of "special needs services" may cause similar disputes between taxpayers and the IRS. In addition, taxpayers making similar expenditures are likely to treat them differently.

The two part test to determine limits on room and board distributions from Coverdell education savings accounts or a qualified tuition program adds unnecessary complexity in calculating benefits. In addition, the second part of this test is difficult to administer given the wide variety of student housing arrangements regarding ownership and operation.

Proposal

The proposal would define qualifying higher education institutions for purposes of the higher education provisions by reference to institutions eligible to participate in federal student aid programs under Title IV of the Higher Education Act of 1965, and not Code section 170(b)(1)(A)(ii)

Under the proposal, tuition and fees required for enrollment or attendance would be treated as qualifying expenses for purposes of the higher education provisions. However, qualifying expenses for tuition or fees would exclude: (i) expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program, (ii) nonacademic fees, and (iii) tuition or fees that entitle the student to any services for room or board.

The proposal would also conform the treatment of books, supplies and equipment for Coverdell educational savings accounts, qualified tuition programs, and scholarships and fellowships (the remaining provisions do not treat these items as qualifying expenses). For purposes of these provisions, qualifying expenses would be defined to include expenses for books, supplies, and equipment required for enrollment or attendance. The definition would exclude such expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program. In addition, the amount of qualifying expenses for books, supplies, and equipment could not exceed the allowance (applicable to the student) for books and supplies included in the "cost of attendance" as determined by the institution for purposes of federal financial aid programs.[37]

[37] See footnote 36.

"Special needs services" would be defined as expenses incurred with respect to personal attendants (such as readers for the blind) and adaptive equipment, including adaptive computer software, incurred in connection with a student's enrollment, attendance or courses of instruction.

The two part test for determining how much can be received tax-free for room and board for postsecondary education would be eliminated. Distributions for room and board would be excluded only to the extent they do not exceed the allowance (applicable to the student) for room and board included in the cost of attendance as determined by the institution for federal student aid purposes.[38]

Repeal Coverdell Income Limits

Current Law

Individuals who make contributions to Coverdell education savings accounts are subject to an income limitation regarding the maximum contribution of $2,000 per year. The allowable contribution phases out between $95,000 and $110,000 of modified AGI ($190,000 to $220,000 for joint returns). There is, however, no limit on the number of accounts that may be established for a single beneficiary and persons other than individuals, e.g., corporations or charities, can also make contributions up to the $2,000 per year limit with respect to any single beneficiary.

Reason for Change

The current income phase-out rule for Coverdell education savings accounts adds complexity and compliance burdens but has little effect on limiting the tax benefits available to beneficiaries because contributions can be made by multiple individuals with respect to the same beneficiary (as long as aggregate annual contributions do not exceed $2,000). For example, grandparents and other relatives, who may not be affected by the income-related limitations, may contribute to Coverdell education savings accounts for a given beneficiary even if the parents' income precludes them from making such contributions themselves. Also, there are no similar income limitations with respect to contributions to qualified tuition programs that serve the same objective as that of Coverdell accounts with respect to higher education.

Proposal

This proposal would repeal the current-law phase out of the maximum contribution that could be made to a Coverdell education savings account by individuals. Contributions could continue to be made by corporations, charitable organizations, and other entities without regard to their income. Multiple accounts could continue to be established for the same beneficiary (as long as aggregate annual contributions do not exceed $2,000).

The proposals would be effective for taxable years beginning after December 31, 2004.

[38] This proposal would not affect the two part test with respect to elementary and secondary education.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-19	-94	-311	-294	-282	-1,000	-2,558

ALLOW ANNUAL REPORTING AND PAYMENT OF COMBINED STATE AND FEDERAL UNEMPLOYMENT INSURANCE TAXES BY EMPLOYERS OF HOUSEHOLD EMPLOYEES

Current Law

Household employees generally are covered by unemployment insurance, and household employers must pay separate federal and state unemployment insurance taxes. The federal portion of the unemployment tax (FUTA) — together with social security and Medicare taxes — for household employees is calculated on Schedule H and is paid with the employer's form 1040, if not already prepaid through estimated tax payments or withholding.[39] State unemployment insurance tax returns are filed quarterly, along with tax payments, directly to each state in which the employment occurred. The state thresholds for coverage, the state tax rates that apply, the forms used, and benefit qualifications and amounts are determined by each state.

Reasons for Change

Household employers express concern about the burdens of complying with the various employment tax requirements for household employees. Those burdens are often blamed for the failure of household employers to report the income of household employees, or otherwise comply with employment tax requirements. In 1993, statutory changes eliminated for household employers the requirements for separate federal tax returns for social security and Medicare taxes and for the FUTA tax. The reporting and payment of those taxes were incorporated into the federal income tax return of the employer, although employers still are required to provide Forms W-2 (Wage and Tax Statements) to their employees and to file the W-2s and a covering return (Form W-3) with the Social Security Administration.

The 1993 changes, however, did not address the burdens on household employers from quarterly filing of state unemployment insurance returns and the need to make separate, typically very small, payments for state unemployment insurance premiums. Household employers typically complain that, when they become a household employer for the first time, it is difficult to obtain the required information to enable them to begin filing returns and making payments on a timely basis. The administrative burdens of such returns and payments (and the penalties for inadvertent failures) are often disproportionate to the size of the required payments. Similarly, the administrative costs for state unemployment insurance agencies of maintaining accounts, collecting the taxes, and processing the tax returns are very large relative to the taxes collected. Such costs are ultimately borne by the Federal Government since most administrative costs are paid through allocations from the FUTA trust funds.

The difficulties with, and the burdens from, state unemployment insurance reporting and payments may tend to increase noncompliance. Moreover, noncompliance with state unemployment insurance requirements may lead to, or be associated with, noncompliance for social security and Medicare taxes. The lack of such reporting then results in widespread failures by workers to report the income for income tax purposes. Changes in unemployment insurance

[39] Household employers are subject to FUTA if they pay total cash wages to all household employees of $1,000 or more in any calendar quarter of the current or preceding year.

reporting that would reduce employer burdens would promote compliance by household employers and the reporting of income by household employees.

Proposal

For household employers, the separate reporting of wages and the payment of taxes for unemployment insurance purposes to state unemployment insurance agencies would be eliminated. Instead, household employers would pay a single, combined state and federal unemployment insurance tax to the Federal Government, with reporting combined with social security and Medicare taxes on a schedule to be filed annually with the employer's annual individual income tax return. The combined annual reporting would be on a slightly expanded Schedule H of Form 1040, which is currently used to report social security earnings, Medicare earnings, and FUTA earnings of household workers. Actual payment of unemployment insurance taxes for household employees would be combined with the payment of other tax liabilities reported on Form 1040. The income threshold for requiring unemployment insurance coverage, the ceiling on each employee's covered wages, and the tax rate would be uniform nationally. The unemployment insurance tax rate of household employers would not be experience-rated, but the tax rate would be subject to annual adjustment based on overall experience so that revenues collected were sufficient to cover all, or a pre-determined fraction of, aggregate benefit payments and administrative costs.

As under the current system, unemployment insurance benefits would be paid by state unemployment insurance agencies, with benefit eligibility and benefit levels determined by state laws. Benefit payments and administrative costs would be reimbursed by the Federal Government from the combined federal-state tax collected from household employers.

The proposal would be effective for tax years beginning after December 31, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-20	-1	-1	-1	-1	-24	-30

SIMPLIFY TAXATION OF CAPITAL GAINS ON COLLECTIBLES, SMALL BUSINESS STOCK AND OTHER ASSETS

Current Law

Short-term capital gains of individual taxpayers are taxed at ordinary rates. Long-term capital gains (generally 1 year or more) are taxed separately from other income, generally at rates of 5 percent (for gains that would otherwise be taxed at the 10 or 15 percent rates) and 15 percent (for gains otherwise taxed at higher rates). In 2008, taxpayers in the 10 and 15 percent brackets will qualify for a zero percent tax rate on long-term gains. Capital gains are generally taxed at the same rates under the alternative minimum tax (AMT) as under the regular tax. Special rates apply to capital gains on certain small business stock, collectibles, and certain real property.

Gains from the sale of certain small business stock qualify for a 50-percent exclusion subject to a 28 percent maximum rate, resulting in a maximum effective rate of 14 percent (Section 1202). However, the AMT preference on excluded small business stock gains results in an effective rate of 14.98 percent. To be eligible for the exclusion, the stockholder must have been the original purchaser of the stock and have held the stock for at least 5 years. In addition, the total assets of the corporation, including the proceeds of the stock sale, cannot exceed $50 million through the time of issue. The business must have met various requirements on eligible types of business activities, stock redemptions, working capital, holdings of real estate, and active business assets throughout the stockholder's holding period. A provision enacted in 1997 allows capital gains from the sale of small business stock held more than 6 months to be rolled over into new investments in other qualified small business stock (Section 1045).

Long-term gains on collectibles are taxed at ordinary tax rates subject to a 28 percent maximum rate. Collectibles include works of art, antiques, stamps and coins, metal or gems, alcoholic beverages, and other tangible personal property defined in regulations.

For non-corporate taxpayers, gain on Section 1250 real property is allocated into three parts: ordinary gain, unrecaptured Section 1250 gain, and capital gain. Ordinary gain, generally the portion previously deducted as accelerated depreciation (i.e., depreciation in excess of straight-line depreciation), is recaptured by treating it as ordinary gain rather than capital gain. Unrecaptured Section 1250 gain, generally the portion previously deducted as straight-line depreciation, is taxed at ordinary tax rates up to a maximum rate of 25 percent. Capital gain, generally the increase in value above original cost, is taxed at capital gains tax rates.

Reasons for Change

Schedule D and the associated forms and instructions are more complicated than necessary because of the special 25 percent and 28 percent rates that apply in only a small fraction of cases. For example, the 28 percent rate requires an extra column on Schedule D and two worksheets of 51 and 7 lines, but affects only about 1 percent of taxpayers with capital gains (about 240,000 taxpayers). There are also complicated rules for calculating how these provisions interact with other capital gains and losses in particular cases. Eliminating the 25 and 28 percent special rates would simplify capital gains forms and calculations. About one in five taxpayers (more than 20 million) report capital gain or loss in a given year, and more than twice as many taxpayers report

capital gain or loss over time. Thus a large fraction of taxpayers would benefit from simplification of capital gains taxes.

Because of complicated eligibility rules, the 50 percent exclusion and rollover provision for gains on certain small business stock create compliance problems for taxpayers and enforcement problems for the IRS. Corporations with eligible stock are not required to register with the IRS or inform their shareholders whether gains on their stock are eligible for the exclusion. Thus, neither shareholders nor the IRS are likely to know whether particular shares of small business stock are eligible. In addition, taxpayers receive little benefit from the exclusion under current law, because the tax rate for eligible stock is only slightly below the regular capital gains tax rate, particularly if the taxpayer is subject to the AMT.

Collectibles are taxed at ordinary rates with a maximum rate of 28 percent because Congress did not extend the 1997 capital gains tax cuts to collectibles, as doing so was considered inconsistent with the goal of increasing incentives for productive investment. Unrecaptured Section 1250 gains are taxed at ordinary rates with a maximum rate of 25 percent because such gains result from previous depreciation deductions at higher ordinary tax rates. While based on tax policy considerations, these special provisions create complexity for all taxpayers with capital gains by creating two additional tax rates, requiring additional instructions and worksheet calculations, and adding lines and an additional column to Schedule D. Despite adding complexity, these two provisions provide no benefit for taxpayers in the 10 percent, 15 percent and (for collectibles) 25 percent ordinary income-tax brackets.

Proposal

The proposal would eliminate the 25 percent and 28 percent capital gains tax rates, greatly simplifying capital gains tax calculations and forms. The 28 percent rate would be eliminated by repealing the 50 percent exclusion and rollover provision for small business stock (Sections 1202 and 1045), and by taxing 50 percent of the capital gains on collectibles as long-term capital gains and 50 percent as short-term capital gains. For collectibles, this produces a maximum effective rate of 25 percent in the 35 percent tax bracket (i.e., 25% = 0.50*15% + 0.50*35%) and lower rates in lower tax brackets. Similarly, the 25 percent rate would be eliminated by taxing 50 percent of Section 1250 gain as long-term capital gain and 50 percent as ordinary income. The maximum effective rate for unrecaptured Section 1250 gain remains 25 percent and rates are reduced in lower tax brackets. For assets with unrecaptured Section 1250 gain, the gain reflecting an increase in value over original cost would continue to be taxed at regular capital gains tax rates. The proposals would be effective for tax years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-2009	2005-2014
($ in millions)							
-*	-4	5	11	-1	-17	-6	-35

* Less than one million

STRENGTHEN THE EMPLOYER BASED PENSION SYSTEM

ENSURE FAIR TREATMENT OF OLDER WORKERS IN CASH BALANCE CONVERSIONS AND PROTECT DEFINED BENEFIT PLANS

Current Law

Qualified retirement plans consist of defined benefit plans, which allocate investment risk to the plan sponsor, and defined contribution plans, which allocate investment risk to plan participants. In recent years, many plan sponsors have adopted cash balance and other "hybrid" plans that combine features of defined benefit and defined contribution plans. A cash balance plan is a defined benefit plan that provides for annual "pay credits" to a participant's "hypothetical account" and "interest credits" on the balance in the hypothetical account. As with traditional defined benefit plans, the sponsor of a cash balance plan bears investment risk (as well as some mortality risk), and benefits are guaranteed by the Pension Benefit Guaranty Corporation. Otherwise, the cash balance plan functions like a defined contribution plan from the perspective of a participant.

Questions have been raised regarding whether and how cash balance plans satisfy the rules relating to age discrimination and the calculation of lump sum distributions.

Age Discrimination. Code section 411(b)(1)(H) provides that a defined benefit plan fails to satisfy the benefit-accrual rules if, under the plan, a participant's benefit accrual is ceased, or the rate of a participant's benefit accrual is reduced, because of the attainment of any age. Section 204(b)(1)(H) of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4(i)(1)(A) of the Age Discrimination in Employment Act (ADEA) set forth similar rules.

Age-discrimination questions have been raised regarding two aspects of cash balance plans. First, some have argued that pay credits for younger participants provide higher benefits than the same pay credits for older participants because the pay credits for younger participants accrue interest credits over longer periods. Although one federal district court has agreed with this analysis, others have rejected it. *Compare Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (cash balance plan found age-discriminatory) *with Campbell v. BankBoston, N.A.*, 206 F. Supp. 2d 70 (D. Mass. 2002) (cash balance plan found not age-discriminatory), *aff'd*, 327 F.3d 1 (1st Cir. 2003), *and Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000) (same).

Second, some have argued that "conversions" of traditional defined benefit plans to cash balance plans disadvantage older participants. A conversion occurs when a plan sponsor amends a traditional plan to make it a cash balance plan. A conversion can result in lower future accrual rates for some or all participants. If this occurs, ERISA section 204(h) and Code section 4980F require that participants receive advance notice. The conversion can also result in "wear-away" – a period following the conversion during which a participant's prior accrued benefits under the traditional plan exceed the benefits payable under the cash balance plan. Thus, during wear-away, the benefits under the cash balance formula of some or all participants must "catch up" with benefits accrued under the traditional plan. Wear-away may occur for the normal retirement benefit, the early retirement benefit, or both. However, under Code section 411(d)(6)

and ERISA section 204(g), the conversion may not reduce the accrued normal or early retirement benefit of any participant.

Some have argued that the adverse effects of cash balance conversions fall more heavily on older participants than on younger participants because traditional plans usually provide more valuable accruals to older and longer-service participants. Many plan sponsors have adopted strategies to mitigate these effects, including protection of participant expectations through "choice" and "grandfathering" as well as avoidance of wear-away. However, these strategies have been voluntary, as current law generally gives the plan sponsor broad authority to amend a plan for any reason at any time. *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 443 (1999).

In December of 2002, Treasury and the IRS proposed regulations to address these and other age-discrimination issues. 67 *Fed. Reg*. 76123 (Dec. 11, 2002). The proposed regulations provide that a cash balance formula is not discriminatory as long as pay credits for older participants are equal to or greater than pay credits for younger participants. The proposed regulations also provide that cash balance conversions are not discriminatory as long as the conversions satisfy one of three permissible methods specified in the regulations. The proposed regulations do not prohibit reductions in future accrual rates or benefit wear-away because, under the conditions specified in the proposed regulations, those effects are not inherently age-discriminatory.

Calculation of Lump Sum Distributions. Three federal appellate courts have addressed the calculation of lump sum distributions under cash balance plans. *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), *cert. dismissed*, 531 U.S. 1061 (2001); *Lyons v. Georgia-Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000), *cert. denied*, 532 U.S. 967 (2001). All three courts held that a participant's hypothetical account balance must be projected to normal retirement age using the plan's interest crediting rate, converted to an annuity, and then discounted to a lump sum using the section 417(e) interest rate. If the plan's interest crediting rate is the section 417(e) rate, the present value of the normal retirement age annuity will be the same as the hypothetical account balance. However, if the plan's interest crediting rate is higher than the section 417(e) rate, the present value of the normal retirement age annuity – and the amount of any lump sum distribution – will be greater than the hypothetical account balance. This result is sometimes referred to as "whipsaw."

These federal court decisions have followed an analysis set out in IRS Notice 96-8. Many plan sponsors have responded to whipsaw by limiting the interest crediting rate to the section 417(e) rate (or a deemed equivalent). This response effectively makes the section 417(e) rate a ceiling on plan interest credits.

Reasons for Change

Although cash balance plans and cash balance conversions are not inherently age-discriminatory, current law does not provide adequate protection for older workers in every conversion. For example, the statutory age-discrimination rules do not prevent a plan sponsor from changing future benefit accruals. Also, current law does not prevent a plan sponsor from imposing wear-away of normal or early retirement benefits. (Current law actually restricts certain transition practices, such as preserving the value of early retirement subsidies through additions to

participant account balances.) Many plan sponsors have voluntarily tried to mitigate any adverse effects that cash balance conversions may have on older and longer-service participants.[40] However, ensuring the fair treatment of older and longer-service participants in conversions requires strengthening current law to guarantee reasonable transition protections and to prohibit benefit wear-away.

Inconsistent federal court decisions make it necessary to clarify that cash balance plans are not inherently discriminatory as long as older participants are treated at least as well as younger participants. Removing uncertainty about the basic legality of cash balance plans is critical to preserving the vitality of the defined benefit system, which provides retirement income security for millions of American workers and their families.

As applied by the courts, the whipsaw effect under Notice 96-8 has harmed participants by leading plan sponsors to limit interest credits to the section 417(e) rate. This results in lower retirement accumulations for participants. The whipsaw effect should be eliminated so that plan sponsors can give participants higher interest credits.

Proposal

The proposal would accomplish three major objectives:

1. Ensure fairness for older workers in cash balance conversions.

2. Protect the defined benefit system by clarifying the status of cash balance plans.

3. Remove the effective ceiling on interest credits in cash balance plans.

Ensure fairness for older workers in cash balance conversions. The proposal would provide new protections for participants in cash balance conversions that would ensure fair transitions from traditional plans to cash balance plans. For each of the first five years after a conversion, the benefits earned by any current participant under the cash balance plan would have to be at least as valuable as the benefits the participant would have earned under the traditional plan if the conversion had not occurred. Additionally, there could be no wear-away of normal or early retirement benefits for any current participant at any time.

To prohibit violations of the new transition protections, there would be a 100 percent excise tax, payable by the plan sponsor, on any difference between the benefits required under the proposal and the benefits actually provided by the cash balance plan. In recognition of the fact that some plan sponsors may be experiencing adverse business conditions, the amount of the excise tax could not exceed the greater of the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income. Failure to implement the new transition protections would not result in disqualification of the plan.

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[40] The General Accounting Office reported that 84 percent of the employers that it surveyed provided full or partial transition relief in cash balance conversions. General Accounting Office, *Private Pensions: Implications of Conversions to Cash Balance Plans* at 33 (GAO/HEHS-00-185, Sept. 29, 2000); General Accounting Office, *Cash Balance Plans: Implications for Retirement Income* at 34-5 (GAO/HEHS-00-207, Sept. 29, 2000).

The excise tax would not apply if participants were given a choice between the traditional formula and the cash balance formula or if the cash balance conversion grandfathered current participants under the traditional formula. This would preserve flexibility of plan sponsors to implement other provisions that protect older and longer-service participants.

Protect the defined benefit system by clarifying the status of cash balance plans. The proposal would clarify that a cash balance plan satisfies the age-discrimination rules if the plan provides pay credits for older participants that are not less than the pay credits for younger participants, in the same manner as any defined contribution plan. The proposal would also clarify that certain transition strategies used in conversions (such as preserving the value of early retirement subsidies) do not violate the age-discrimination or other qualification rules. The proposal would provide similar rules for other types of hybrid plans and for conversions from traditional plans to other types of hybrid plans.

Remove the effective ceiling on interest credits in cash balance plans. The proposal would eliminate whipsaw, providing that a cash balance plan may distribute a participant's account balance as a lump sum distribution as long as the plan does not credit interest in excess of a market rate of return. The Secretary would be authorized to provide safe harbors for what constitutes a market rate of return and to prescribe appropriate conditions regarding the calculation of plan distributions. This would permit plan sponsors to give higher interest credits to participants, resulting in larger retirement accumulations.

Conforming amendments and effective date. There would be conforming amendments under ERISA and the ADEA for statutory changes to the existing age-discrimination and distribution rules (but not for the new excise tax).

All changes under the proposal would be effective prospectively. The legislative history would state that there would be no inference as to the status of cash balance plans or cash balance conversions under current law.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	0	0	0	0	0	0	2,373

IMPROVE THE ACCURACY OF PENSION LIABILITY MEASURES

Current Law

Defined benefit pension plans are subject to minimum funding requirements and limits on maximum deductible contributions. In the case of a single-employer defined benefit plan maintained by an employer who has more than 100 employees participating under defined benefit plans sponsored by that employer, the minimum funding requirements established under ERISA are supplemented by a deficit reduction contribution.

The deficit reduction contribution is based on the plan's current liability. For plan years beginning in 2004, current liability is required to be calculated using an interest rate that is within 90-105 percent of the weighted average of the rate of interest on 30-year Treasury securities, where the average is determined for the 48 months ending with the month preceding the first day of the plan year. Current liability is calculated using a statutorily specified mortality table.

Current liability is also relevant in determining the maximum deductible contribution to a defined benefit pension plan. Under section 401(a)(1)(D), an employer's contributions to a defined benefit plan do not exceed the maximum deductible amount so long as they are less than the amount necessary to bring the plan's assets up to the current liability (determined without regard to plan amendments made in the last 2 years in the case of a plan which has 100 or fewer participants for the plan year).

Under section 401(a)(29), an employer sponsoring a single employer plan with assets less than 60 percent of current liability (determined without regard to the unamortized portion of pre-1989 unfunded current liability) that amends the plan to increase benefits is required to post security before the plan amendment can take effect. The amount of the security is the excess of the assets needed to increase the plan's funded current liability percentage to 60 percent (or, if less, the amount of increases in current liability attributable to all post-1988 benefit increases) over $10 million.

Under section 401(a)(33), an amendment to a defined benefit plan sponsored by an employer in bankruptcy improving the benefits under the plan generally may not be made effective until the reorganization is complete. Under section 412(f), if an employer has an outstanding minimum funding waiver for a defined benefit plan, the plan generally may not be amended to improve benefits until the waiver is fully amortized.

In the case of a distribution of a lump sum (and certain other benefit forms that do not provide for lifetime payments), the amount of the distribution must be no less than the amount determined using a statutorily specified interest rate and mortality table. The interest rate is the average of the rate of interest on 30-year Treasury securities for the month preceding the distribution or, in accordance with regulations, at some earlier time as established under the plan.

Reasons for Change

Interest rates used for determining an employer's pension funding obligations should accurately

reflect the cost of settling its pension liability. Changes in the financial markets have fundamentally altered the relationship between the interest rate on the 30-year Treasury bond and interest rates on other fixed income securities. As a result of those changes, while 105 percent of the interest rate on 30-year Treasury securities may have been an appropriate interest rate to be used in discounting pension liabilities in the past, this is no longer the case today. The continued use of 105 percent of the interest rate on 30-year Treasury securities overstates the cost of settling an employer's pension liability. This in turn dramatically increases the funding requirements for sponsors of many plans at a critical phase in the economic expansion.

The interest rates used for current liability purposes should be based on market-determined interest rates for similar obligations. An employer's pension promise need not be quite as secure as the full faith and credit guaranty of the Treasury security, but should be as safe as a high-quality corporate bond. Accordingly, the interest rates for determining current liability should be based on interest rates on high-quality corporate bonds.

The interest rates used to determine current liability should also reflect the timing of future benefit payments under the plan. To the extent that a plan will be making the bulk of its benefit payments in the next few years, the interest rates used to discount those payments should be the market yields for shorter-term bonds. Conversely, to the extent a plan will be making most of its payments far into the future, it is appropriate to use longer-term yields to discount those payments. These steps would improve the accuracy of the liability measurement.

The interest rates used to determine pension liabilities should reflect current market conditions, rather than the potentially stale interest rates of 2 years ago. Any smoothing in interest rates should be just sufficient to reduce short term market volatility without reducing measurement accuracy. Calculations of pension liability using current market conditions would enable plan sponsors to make a realistic assessment of their plans' funded status.

The current use of the rate of interest on 30-year Treasury securities for purposes of determining lump sums creates a mismatch between the amount of an employee's lump sum and the value of the annuity that the employee would otherwise receive. This mismatch may create an incentive for retirees to select one form of benefit payment (a lump sum) rather than an annuity. Changing the interest rate used to determine lump sums to market-determined interest rates that reflect the timing of expected benefit payments would remove this bias and ensure that the amount of the lump sum is the same as the value of the annuity. Any such change should provide a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law.

Proposal

For plan years beginning in 2004 and 2005, current liability would be determined using a weighted average of the yields on high-quality long-term corporate bonds. The average would be determined for the 48 months ending with the month preceding the first day of the plan year.

Beginning in 2008, current liability would be determined using a series of interest rates drawn from a yield curve of high-quality zero-coupon bonds with various maturities. The maturities would be selected to match the amounts and timing of when benefit payments are expected to be

made from the plan. The yield curve would be issued monthly by the Secretary of Treasury and would be based on the 90-day average of interest rates for high quality corporate bonds.

For plan years beginning in 2006 and 2007, current liability would be determined as the weighted average of the value of the current liability determined using the methodology applicable to 2004 and 2005 and the value of the current liability determined using the methodology applicable to 2008 and beyond. For 2006, the weighting factor would be 2/3 for the "old" methodology and 1/3 for the new methodology; and for 2007, the weighting factors would be reversed.

For plan years beginning in 2004 and 2005, there would be no change in the law relating to determination of lump sums from defined benefit plans. However, beginning in 2008, lump sum calculations would also be calculated using rates drawn from the zero-coupon corporate bond yield curve. Thus, the interest rate that would apply would depend on how many years in the future a participant's annuity payment will be made. Typically, a higher interest rate would apply for payments made further out in the future.

For distributions in 2006 and 2007, lump sum calculations would be determined as the weighted average of the value of the lump sum determined using current law and the value of the current liability determined using the methodology applicable to 2008 and beyond. For 2006, the weighting factor would be 2/3 for the "old" methodology and 1/3 for the new methodology; and for 2007, the weighting factors would be reversed.

If a plan sponsored by an employer with a below investment grade credit rating has assets less than 50 percent of termination liability, the plan would be required to be frozen (i.e., no additional accruals would be permitted), but service would continue to be earned for purposes of vesting and eligibility for benefits. In addition, such a plan would be required to suspend lump sums (and other forms of accelerated benefit payments, including the purchase of annuities).

The proposal generally would be effective for plan years beginning in 2004. The requirement for a freeze of accruals and the suspension of lump sums for a plan that is funded less than 50 percent of termination liability that is sponsored by an employer with a below investment grade credit rating would be effective for plan years beginning in 2005.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
8,537	12,297	7,340	3,042	-1,586	-5,467	15,626	-15,869

CLOSE LOOPHOLES AND IMPROVE TAX COMPLIANCE

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).

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.

In order to prevent the double taxation of a taxpayer's foreign source income – taxation of the same income by the source country where the income is earned and by the United States – taxpayers are permitted a credit for certain foreign taxes. The amount of foreign taxes that may be credited each year generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income. 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 capability 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 percent 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 percent 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 percent of the fees paid to the promoter or $200,000. This penalty would be increased to 75 percent 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 on behalf of 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 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.

In addition, the proposal would grant regulatory authority to the Treasury Department in order to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income in cases where taxes are imposed on any person in respect of income of an entity. Because the types of transactions involved are varied, the regulations could provide for either the disallowance of a credit for all or a portion of the foreign taxes, or the allocation of the foreign taxes among the participants to the transaction in a manner that is more consistent with the underlying economics of the transaction.

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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	46	63	85	113	128	435	1,071

LIMIT RELATED PARTY INTEREST DEDUCTIONS

Current Law

Section 163(j) of the Code applies to limit the deductibility of certain interest paid by a corporation to related persons ("disqualified interest"). Disqualified interest for these purposes generally means interest paid or accrued by a corporation to a related person if such interest income is not subject to federal income tax. Disqualified interest also includes interest paid or accrued by a corporation to an unrelated person if the underlying indebtedness is guaranteed by a related foreign person or tax exempt organization and such interest is not subject to U.S. withholding tax. The limitations of section 163(j) only apply to a corporation with a debt-to-equity ratio that exceeds 1.5 to 1. If such a corporation has net interest expense that exceeds 50 percent of its adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction), no deduction is allowed for disqualified interest in excess of the 50-percent limit. Interest that is disallowed in a taxable year under section 163(j) may be carried forward for deduction in a future year; there is no time limit on this carryforward. In addition, excess limitation (i.e., the amount by which the corporation's 50-percent limit exceeds its net interest expense for a taxable year) may be carried forward up to three years.

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.

Proposal

Section 163(j) would be revised to tighten the limitation on the deductibility of interest paid to related persons. The current law 1.5 to 1 debt-to-equity safe harbor would be eliminated. The adjusted taxable income threshold for the limitation would be reduced from 50 percent to 25 percent of adjusted taxable income with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee (hereinafter referred to as "guaranteed debt"). Interest on guaranteed debt generally would be subject to the current law 50 percent of adjusted taxable income threshold. The indefinite carryforward for disallowed interest under the adjusted taxable income limitation of current law would be limited to ten years. The 3-year carryforward of excess limitation would be eliminated.

The proposal would be effective on the date of first committee action.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-51	93	146	203	265	656	3,116

MODIFY QUALIFICATION RULES FOR TAX-EXEMPT PROPERTY CASUALTY INSURANCE COMPANIES

Current Law

Section 501(c)(15) provides that an insurance company that is not a life insurance company (a "property-casualty insurance company"), and which has $350,000 or less of net written premiums (or direct written premiums, if greater) during the taxable year, is tax-exempt. The only limit on the amount of investment income or assets that the insurance company may hold is the requirement that the entity be primarily engaged in the insurance business to qualify as an insurance company. Section 501(c)(15)(A), section 831(a), section 1.801-3(a). Section 816(a) provides that a company is an insurance company only if more than half of its business is the insurance business, but this test only applies for purposes of determining whether an insurance company is a life insurance company for federal tax purposes.

Section 831(b) allows a property-casualty insurance company with annual written premiums (as defined above) that exceed $350,000, but which do not exceed $1,200,000, to elect to be taxed on its taxable investment income.

In determining whether a property casualty insurance company is tax-exempt under section 501(c)(15) or qualifies for the elective tax regime in section 831(b), premiums of companies in the same controlled group are aggregated. For purposes of these provisions, a controlled group is defined in accordance with the rules contained in section 1563, as modified by section 831(b)(2)(B) to include life insurance companies and to use a lower 50 percent ownership standard rather than the 80 percent standard set forth in section 1563. The definition of a controlled group does not, however, include other related tax-exempt insurance companies or foreign insurance companies, and, therefore, premiums received by these entities are not aggregated for purposes of determining whether an insurance company qualifies for exemption under section 501(c)(15).

Section 4371 imposes a four percent excise tax on property-casualty insurance policies directly insuring U.S. risks and issued by a foreign company to a domestic corporation or partnership, a U.S. resident, or a foreign entity or individual engaged in a trade or business within the United States. Section 4371 also imposes a one percent excise tax on premiums paid for property-casualty reinsurance or life insurance contracts issued by a foreign company with respect to U.S. risks.

Section 953(d) allows a 25 percent U.S.-owned foreign insurance company to elect to be taxed as a domestic insurance company if it meets certain requirements, including the requirement that the foreign insurance company would qualify for taxation as an insurance company under Part I or II of subchapter L for the taxable year if it were a domestic corporation.

Reason for Change

Section 501(c)(15) originally was designed to provide a tax exemption for small bona fide mutual property-casualty insurance companies (such as entities formed to insure farmers) with

gross receipts of $150,000 or less. Similarly, only small mutual companies with gross receipts between $150,000 and $500,000 were eligible to make the section 831(b) election.

In 1986, Congress expanded section 501(c)(15) to provide tax-exemption to stock as well as mutual property-casualty insurance companies with written premiums, rather than gross receipts, of $350,000 or less. Treasury has become aware that, since enactment of the 1986 changes, the section 501(c)(15) tax exemption has been used inappropriately to accumulate investment income tax-free. Several companies have been established as foreign insurance companies in tax- and regulatory-friendly jurisdictions, and, in order to avoid the excise tax on foreign-issued insurance and reinsurance policies, have elected to be treated as tax-exempt domestic insurance companies.

Proposal

The proposal would modify section 501(c)(15) to provide that tax exemption is available only for a domestic mutual property-casualty insurance company (not including a foreign company that has made an election under section 953(d)), which is organized within, and subject to regulation in, a single state, and which only writes insurance or reinsurance contracts on risks located within that same state. The proposal would further modify section 501(c)(15) so that the tax exemption would apply only to such a company with gross income of no more than $350,000. For purposes of section 501(c)(15), gross income would include premiums earned, investment income, and other types of gross income. For purposes of determining eligibility of the insurance company for tax-exempt status under section 501(c)(15), the proposal would modify the applicable controlled group rules to aggregate the gross income of U.S. and foreign taxable and tax-exempt insurance companies, as well as the gross income of any related non-insurance companies.

The proposal would modify section 831(b) so that the election to be taxed on taxable investment income is available to any property-casualty insurance company with net written premiums (or direct written premiums, if greater) of $1,200,000 or less. For purposes of determining the eligibility of the insurance company to make an election under section 831(b), the proposal would modify the applicable controlled group rules to aggregate premiums of U.S. and foreign insurance companies, including the premiums of any related tax-exempt insurance companies.

The proposal would also clarify the rules for determining whether a property-casualty insurance company is an insurance company for U.S. tax purposes. Specifically, the proposal would conform the definition of a property-casualty insurance company to the definition set forth in section 816(a) by requiring that more than half of the business of a property-casualty insurance company be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Finally, the proposal would grant the Secretary discretion to develop appropriate reporting requirements to assure compliance with these rules.

The proposal would be effective for taxable years beginning after the date of enactment.

No inference should be drawn regarding whether existing companies claiming to be insurance companies eligible for tax exemption or to be treated as small companies eligible to make the

election under section 831(b) are insurance companies for federal tax purposes under current law.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	67	114	116	119	121	537	1,184

INCREASE PENALTIES FOR FALSE OR FRAUDULENT STATEMENTS MADE TO PROMOTE ABUSIVE TAX SHELTERS

Current Law

A penalty is imposed on any person making or furnishing a false or fraudulent statement in connection with the organization, participation, or sale of an interest in a tax shelter, such as a partnership or other entity, investment plan, or any other plan or arrangement. The amount of the penalty is the lesser of $1,000 or 100 percent of the gross income derived by the person from the organization, participation, or promotion of the tax shelter. The penalty applies to any statement that the person knows or has reason to know is false or fraudulent as to any material matter relating to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest or participating in the tax shelter. The penalty also applies to certain statements regarding the value of any property or services if stated value exceeds 200 percent of the correct valuation.

Reasons for Change

The current penalty amount is insufficient to deter tax shelter promoters from making false or fraudulent statements regarding the purported benefits of an abusive transaction.

Proposal

The Administration's proposal would increase the penalty to 50 percent of the income derived by the person making or furnishing the false statement in connection with the promotion of a tax shelter. The enhanced penalty would not apply to valuation overstatements.

The proposal would be effective for activities after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
[41]--	--	--	--	--	--	--	--

[41] Included in combat abusive tax avoidance transactions

PREVENT ABUSIVE OVERVALUATIONS ON DONATIONS OF PATENTS AND OTHER INTELLECTUAL PROPERTY

Current Law

In general, a taxpayer may claim a deduction for charitable contributions, subject to certain limitations based on the type of taxpayer, the property contributed and the type of donee organization. In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution. There are, however, several exceptions to the general fair market value deduction rule. For example, in the case of certain contributions of inventory and other tangible personal property the amount of the deduction is limited to the lesser of the taxpayer's basis (typically cost) in the donated property or fair market value. In the case of a contribution of a copyright that is not a capital asset,[42] the deduction is limited to the taxpayer's basis.

Reasons for Change

Some taxpayers are claiming substantially inflated deductions for donations of patents and similar intellectual property to charities. Typically, the valuations for these deductions are based on income projections that far exceed the actual income potential of the patent or other intangible.[43] Most often, the taxpayer no longer plans to use the intangible in its trade or business, and the intangible would have little market value if the taxpayer attempted to sell the intangible.

The IRS faces significant administrative burdens in examining valuation issues, because the IRS must employ outside valuation experts and because the nature of the property interests transferred, the actual rights given to the transferee to exploit the property and the restrictions placed on those rights all have an impact on the value of the property.

Proposal

If a taxpayer contributes a patent or other intellectual property (other than certain copyrights) to charity, the taxpayer's initial deduction would be limited to the lesser of the taxpayer's basis in the donated property or the fair market value of the property. In addition, the taxpayer would be permitted to deduct certain additional amounts based on the amount of royalties or other revenue, if any, actually received by the donee charity from the donated property. The amount of the additional deduction would be calculated as a sliding-scale percentage of revenues actually received by the donee charity from the donated property. The taxpayer would be permitted to claim a deduction equal to 100 percent of any revenue from the donated property received by the donee charity from the date of the contribution through the end of the charity's first complete taxable year following the date of the contribution. The applicable percentage would be reduced annually thereafter. The taxpayer would be permitted to claim a deduction equal to 90 percent of

[42] Sections 1221(a)(3) and 1231(b)(1)(C).

[43] For example, the New York Times reported on March 17, 2003, that one corporation claimed a deduction for $83.5 million and, three years later, the donee university's licensing revenue from the donated property totaled only $335,000.

any revenue from the donated property received by the donee charity in the second taxable year beginning after the date of the contribution, 80 percent in the third taxable year, 70 percent in the fourth taxable year, 60 percent in the fifth taxable year, 50 percent in the sixth taxable year, 40 percent in the seventh taxable year, 30 percent in the eighth taxable year, 20 percent in the ninth taxable year, and 10 percent in the tenth taxable year. No additional deduction would be permitted for any revenues received by the donee charity more than 10 years after the date of the contribution or after the expiration of a patent. The taxpayer would be required to obtain written substantiation from the donee charity of the amount of any revenue derived from the donated property during the charity's taxable year.

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

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	432	270	273	277	287	1,539	3,207

PREVENT OVERVALUATIONS AND OTHER ABUSES IN CHARITABLE DONATIONS OF USED VEHICLES

Current Law

In general, a taxpayer may claim a deduction for charitable contributions of tangible personal property subject to certain limitations based on the type of taxpayer, the type of donee organization and the use of the property by the donee organization. The amount of the deduction generally equals the fair market value of the contributed property if the use of the property by the donee is related to its exempt purpose or function. However, the amount of the deduction is limited to the lesser of the taxpayer's basis in the property (typically, cost) or fair market value when the use of the property by the donee is unrelated to the donee's exempt purposes. As a practical matter, taxpayers generally are permitted to deduct the fair market value of donated vehicles, regardless of whether the vehicle is actually used for a charitable purpose or re-sold with the charity receiving some revenue from the sale of the vehicle.

A taxpayer who donates a used car to charity is permitted to use an established used car pricing guide to determine fair market value, but only if the guide lists a sales price for a car of the same make, model and year, sold in the same area, and in the same condition as the donated car. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value. Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal in certain cases. Charities are required to provide donors with written substantiation of donations of $250 or more.

Reasons for Change

In recent years, charities and their agents have actively solicited donations of used vehicles. In most cases, the vehicles are not used for a charitable purpose, but are resold shortly after the donation. Typically, the donated vehicles are sold at auction for wholesale or liquidation prices or to salvage yards for parts. According to a recent report issued by the General Accounting Office, the amounts of deductions claimed by taxpayers often substantially exceed the fair market values of the donated vehicles because taxpayers often use published values for cars in better condition than the donated vehicles.

Proposal

To curtail the problem of excessive donations being claimed for donated vehicles, the proposal would allow a charitable deduction for contributions of vehicles only if the taxpayer obtains a qualified appraisal of the vehicle. Treasury would be permitted to establish an administrative safe harbor in published guidance.

The proposal would not affect the rules governing charitable contributions of inventory property. The proposal would be effective for taxable years beginning after December 31, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	158	102	105	108	112	585	1,197

REFORM THE TAX TREATMENT FOR LEASING TRANSACTIONS WITH TAX-INDIFFERENT PARTIES

Current Law

Under current law, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. A sale-leaseback transaction is respected for federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978). In addition, a sale-leaseback transaction involving "limited use" property for which there is no likely potential lessee or buyer at the end of the lease term other than the original lessee is not respected for federal tax purposes. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

Special rules provide that depreciation deductions relating to property leased to a tax-exempt entity ("tax-exempt use property") must be computed on a straight-line basis, using the longer of the property's assigned class life or 125 percent of the lease term. The length of the lease term for purposes of the 125-percent calculation includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property by agreeing to locate a party to enter into a replacement lease of the property. Tax-exempt entities include federal, state, local, and foreign governmental units, charities, and foreign entities or persons. Tax-exempt use property does not include property subject to leases of less than three years, certain computer software, certain qualified technological equipment, and certain property that is used by a taxpayer to provide services to a tax-exempt entity.

Reasons for Change

Leasing plays an important role as an affordable source of capital. Recently, arrangements have been entered into with tax-indifferent parties, such as foreign and domestic municipalities and tax-exempt organizations, that purport to be leasing transactions but, in substance, provide no financing to the tax-indifferent party aside from a fee. These arrangements have no meaningful financial or economic utility other than the transfer of tax benefits to a U.S. taxpayer (by means of a purported "sale" of property) in exchange for the payment of an accommodation fee to the tax-indifferent party. These arrangements are known as SILOs, or sale-in/lease out arrangements.

For example, a U.S. taxpayer ("Lessor") may purport to "purchase" an existing asset, such as a subway line, stadium, or waste water facility, from a tax-indifferent party for $100 million and

simultaneously lease the property back to the tax-indifferent party.[44] No interruption or change occurs in the actual use, operation, or control of the property. Under the terms of the arrangement, the tax-indifferent party has an option to "repurchase" the property from the Lessor for a predetermined price at the end of the lease.

Approximately 85 percent of the Lessor's $100 million "purchase" price is financed with non-recourse debt. Virtually all (in this example $96 million) of the "purchase" price is set aside in defeasance arrangements and other investments for the benefit of the Lessor and the nonrecourse lender (often in an account at a bank related to the lender). These arrangements are structured to provide the necessary funds to pay the rent due under the lease and to fund the exercise by the tax-indifferent party of its "purchase option" at the end of the lease term. Thus, without any further cost or expenditure, the tax-indifferent party may continue to use the property for the entire lease term and retain all rights to the property at the end of that term. In return for its participation, the tax-indifferent party receives the $4 million difference between the "purchase" price and the amount set aside for the benefit of the Lessor. In essence, the $4 million amount is an accommodation fee received by the tax-indifferent party for selling tax benefits (depreciation on the $100 million "purchase" price) to the Lessor.

In addition to the defeasance arrangements described above, Lessors have used other arrangements, including "loop debt" or "loan backs" by the tax-indifferent party to the Lessor (or an affiliate), collateralized letters of credit, payment undertakings, lease prepayments, deposit agreements, and sinking funds, that are designed to eliminate the Lessor's risk and monetize the tax-indifferent party's tax benefits. Although nominally different, in each case the tax-indifferent party sets aside the capital normally provided or made available to the lessee by a lease transaction. The only capital retained by the tax-indifferent party is the $4 million accommodation fee.

These arrangements also include features designed to ensure that the Lessor will not lose money if the property declines in value. As discussed above, the tax-indifferent party has an option to "reacquire" the property for a predetermined price that is funded as a result of the defeasance arrangements. If the "purchase option" is exercised, the Lessor will recover its equity investment and a fixed return on that investment. It is reasonable to expect a municipality to exercise a funded "purchase option" to prevent the transfer of a public asset, such as a subway line, stadium, or waste water facility, to a private party. Moreover, from a practical and political standpoint, the tax-indifferent party is unlikely to surrender control of an asset such as a subway. Nevertheless, the parties take the position that the "purchase option" is not likely to be exercised.

If the "purchase option" is not exercised by the tax-indifferent party, the Lessor has two other alternatives under the terms of the arrangement. First, the Lessor may take possession of the property. Second, the Lessor may require the tax-indifferent party to locate a third party to enter into a service contract, the terms of which were agreed to at the inception of the arrangement. The third party must agree to receive services to be provided by the Lessor using the leased

[44] Because of the nature of the asset, the tax-indifferent party may not be able to transfer title to the asset to the Lessor. In that case, the "sale" takes the form of a lease by the tax-indifferent party to the Lessor for a period in excess of the expected useful life of the asset, which is treated as a sale for federal tax purposes.

property.[45] In return, the third party must agree to make payments to the Lessor. The payments required by the service contract provide the Lessor with funds to repay the remaining balances of the nonrecourse loans and to enable the Lessor to recoup its equity investment and a return on that investment. If the tax-indifferent party does not locate a third party, the tax-indifferent party (or, in certain cases, an affiliate) must agree to receive services and make the required payments. The service contract is used to shorten the lease term, which results in a shorter tax depreciation recovery period. Whether the "purchase option" or the service contract is selected, the practical effect is that the Lessor recovers its investment plus a return and the Lessor's risk of loss is eliminated.[46]

Considering the totality of the circumstances, the substance of the arrangement is the payment of a small fee to the tax-indifferent party in exchange for tax benefits. No real financing occurs and there is no change in the control, use, operation of, or beneficial interest in, the asset.

Many of these arrangements involve foreign property and provide no benefits to state or local governments or charities in the United States. Even when the arrangement involves U.S. property, the tax benefits purchased by the Lessor, and the corresponding cost to U.S. taxpayers in lost tax revenues, exceed the fee paid to the tax-indifferent party.

Existing rules have proved ineffective in preventing U.S. taxpayers from entering into these and similar arrangements that result in the monetization of tax benefits rather than financing for the tax-indifferent party. Additional rules are necessary to expand the types of assets covered by the existing rules and to limit the ability of a U.S. taxpayer to acquire tax benefits through such arrangements. At the same time, leasing arrangements that provide real financing to tax-indifferent parties should be permitted to continue.

Proposal

Modify the Rules for Depreciation of Tax-Exempt Use Property. The proposal would expand existing rules applicable to tax-exempt use property. The recovery period for property leased to a tax-indifferent party, which is the longer of the property's assigned class life or 125 percent of the lease term, would apply to qualified technological equipment and computer software. Except as provided in regulations, service contracts and other similar arrangements following a lease of property to a tax-indifferent party would be included in the length of the lease term for purposes of the 125-percent calculation. A tax-indifferent party would include federal, state, local, and

[45] As part of any service contract arrangement, it is contemplated that the Lessor will enter into an operating agreement engaging a third party to operate the leased property. The service recipient will be required to reimburse the Lessor for monthly operating expenses in addition to making the minimum payments required under the service contract.

[46] Similar arrangements take advantage of the shorter depreciation periods available for computer software and qualified technological equipment, which comprise a growing proportion of the assets involved in these leasing arrangements. In these arrangements, the Lessor purports to "purchase" equipment having a useful life substantially longer than the recovery period for qualified technological equipment and related software. The terms of these arrangements are similar to the example discussed above. In lieu of a service contact, however, the tax-indifferent party may be required to purchase residual value insurance if it fails to exercise an early buyout option. The residual value insurance requirement, like the service contract, ensures that the Lessor will recoup its equity investment and a return on that investment.

foreign governmental units, charities, foreign entities or persons, and any transferee or accommodation party who enters into a lease of such property with a taxpayer.

Limit Deductions for Leases to Tax-Indifferent Parties. The proposal would limit a taxpayer's deductions or losses related to a lease to a tax-indifferent party to the taxpayer's income from the lease for that taxable year. This limit would apply to all deductions related to a lease to a tax-indifferent party and the leased property. Any disallowed deductions would be carried forward and treated as deductions related to the lease in the next taxable year subject to the same limitations. A taxpayer would be allowed to take previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property subject to a lease to a tax-indifferent party.

A lease to a tax-indifferent party would not be subject to the limit described in the preceding paragraph if the lease satisfies all of the following five requirements. First, the lease is not a lease of property financed with tax-exempt bonds.

Second, the tax-indifferent party does not enter into an arrangement to monetize its lease obligations, including any purchase option, in an amount that exceeds 20 percent of the taxpayer's cost of the leased property. Arrangements to monetize lease obligations would include a defeasance arrangement, a loan by the tax-indifferent party to the taxpayer (or an affiliate), a deposit agreement, a letter of credit collateralized with cash or cash equivalents, a payment undertaking agreement, a lease prepayment, a sinking fund arrangement, any similar arrangement, and any other arrangement identified by the Secretary in regulations. The Secretary would be authorized to promulgate regulations permitting qualified lease treatment even if a tax-indifferent party provides cash-equivalent credit support in excess of 20 percent if the creditworthiness of the tax-indifferent party would not otherwise satisfy the lessor's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's cost of the property. In addition, on the purchase option exercise date, if any, such credit support would not be permitted to exceed 50 percent of the lessee's purchase option price.

Third, the taxpayer makes and maintains a substantial equity investment in the leased property. For this purpose, a taxpayer would not have made or maintained a substantial equity investment unless: (1) the taxpayer makes an unconditional initial equity investment in the property of at least 20 percent of the cost of the leased property; (2) the taxpayer maintains a 20-percent equity investment at all times throughout the term of the lease; and (3) the taxpayer's 20-percent equity investment remains at the end of the lease term.

Fourth, the tax-indifferent party does not assume or retain more than a minimal risk of loss (other than the obligation to pay rent and insurance premiums, to maintain the property or other similar conventional obligations of a net lease) through a put option, a residual value guarantee, residual value insurance, any similar agreement, or any other arrangement identified by the Secretary in regulations. For this purpose, a tax-indifferent party would have assumed or retained more than a minimal risk of loss if: (1) as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-indifferent party, the taxpayer is insulated from any portion of the loss that would occur if the value of the leased property is 25 percent less than the

leased property's projected fair market value at lease termination; (2) as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-indifferent party, the taxpayer is insulated from a risk of loss in the aggregate that is greater than 50 percent of the loss that would occur if the value of the leased property were zero at lease termination; or (3) the tax-indifferent party assumes or retains a risk of loss described by the Secretary in regulations.

Fifth, the lease is not described by the Secretary in regulations.

The proposal would be effective for leases entered into after December 31, 2003. No inference should be drawn regarding the appropriate tax treatment of similar transactions entered into prior to January 1, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
340	1,591	2,712	3,285	3,565	3,766	14,919	33,385

ENSURE FOREIGN SUBSIDIARIES OF U.S. COMPANIES CANNOT INAPPROPRIATELY AVOID U.S. TAX ON FOREIGN EARNINGS INVESTED IN U.S. PROPERTY THROUGH USE OF THE EXCEPTIONS FOR BANK DEPOSITS

Current Law

A U.S. shareholder of a foreign corporation generally is subject to U.S. tax on earnings of that foreign corporation only when such income is repatriated. Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata share of the corporation's investments in certain U.S. property. U.S. property for this purpose generally includes debt obligations of U.S. persons. However, deposits with persons "carrying on the banking business" are excluded from the definition of U.S. property subject to this general rule. In The Limited, Inc. v. Commissioner, 286 F.2d 324 (6th Cir., 2002), the Court of Appeals held that a U.S. affiliate was "carrying on the banking business" even though its operations were limited to administering the U.S. group's private-label credit-card program. Therefore, the court held that certificates of deposit issued by the U.S. affiliate and held by the controlled foreign corporation were covered by the exception and so were not taxable repatriations.

Reasons for Change

The result in The Limited is inconsistent with the policy underlying the exception from U.S. property of deposits with a person carrying on the banking business. This exception is one of several exceptions from the definition of U.S. property that generally were designed to ensure that property held by a controlled foreign corporation for business purposes will not be characterized as a disguised repatriation. The result in The Limited inappropriately extends the exception for deposits with persons carrying on the banking business to cases in which the deposits should be characterized as a repatriation.

Proposal

The Administration proposes to limit the exception for foreign earnings invested in U.S. property as bank deposits to deposits with institutions regulated as banks. The proposal would be effective after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	24	21	22	22	23	112	234

MODIFY TAX RULES FOR INDIVIDUALS WHO GIVE UP U.S. CITIZENSHIP OR GREEN CARD STATUS

Current Law

Under Section 877, for 10 years after an individual's loss of U.S. citizenship or termination of long-term U.S. residency with a principal purpose of avoiding U.S. tax, the individual is subject to an alternative tax regime. Generally, the individual is subject to regular U.S. income tax on an expanded class of income, taxed on certain transfers that otherwise would get non-recognition treatment, and subject to special estate and gift tax rules covering an expanded class of assets.

An individual is presumed to have lost citizenship or terminated long-term residency with a principal purpose of tax avoidance if he meets an average annual net income tax liability test or a net worth test. Certain individuals (e.g., dual citizens) may rebut this presumption by submitting a ruling request within one year of the date of loss of U.S. citizenship asking the IRS for a determination as to whether the loss of citizenship had for one of its principal purposes the avoidance of U.S. tax.

Reasons for Change

The current-law alternative tax regime applicable to former citizens and long-term residents frequently requires a determination of a taxpayer's motive for expatriation. This subjective test can be difficult to administer. Replacing this and other administratively difficult tests with clearer and objective tests and expanding information reporting by individuals who expatriate should help to improve compliance with the alternative tax regime.

Proposal

An individual losing U.S. citizenship or residency would be subject to the alternative tax regime of section 877 if the individual's average annual net income tax liability for the 5 taxable years preceding expatriation exceeds $124,000 (indexed for inflation), the individual's net worth on the date of expatriation exceeds $2 million (indexed for inflation), or the individual fails to certify under penalty of perjury that he complied with his U.S. tax liabilities for the 5 taxable years preceding expatriation. Exceptions would be provided for certain dual citizens and certain U.S. citizens who relinquish citizenship prior to age 18½.

An individual who expatriates would continue to be taxed as a U.S. citizen or resident until the individual gives notice of an expatriating act or termination of residency to the Secretary of State or the Secretary of Homeland Security and provides the statement required by section 6039G (information on individuals losing U.S. citizenship).

Except to the extent provided in regulations, individuals who are subject to the alternative tax regime in a calendar year during the 10-year period following expatriation but who are physically present in the U.S. for more than 30 days in that calendar year generally would be subject to U.S. tax on their worldwide income as though they were U.S. citizens or residents in that taxable year.

Certain gifts of stock of closely-held foreign corporations by a former citizen or former long-term resident would be subject to U.S. gift tax.

Annual reporting would be required for individuals subject to the alternative tax regime, even if they have no U.S. tax liability that year.

The changes would apply to individuals losing U.S. citizenship or long-term residency on or after date of first committee action.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
1	23	20	22	24	25	114	272

EXPAND TAX SHELTER EXCEPTION FOR FEDERAL PRACTITIONER PRIVILEGE

Current Law

In general, a common law privilege of confidentiality exists for attorney-client communications with respect to legal advice. Communications relating to federal tax advice between a taxpayer and a federally authorized tax practitioner (who may not be an attorney) are protected by a statutory confidentiality privilege to the same extent that the communication would be considered a privileged communication if it were between a taxpayer and an attorney. Written communications relating to corporate tax shelters are not covered by the statutory privilege.

Reasons for Change

The exception to the privilege for communications relating to corporate tax shelters should be expanded to all tax shelters, regardless of whether or not the participant is a corporation.

Proposal

The Administration's proposal would modify the federal tax practitioner privilege by expanding the tax shelter exception to cover written communication relating to any tax shelter, regardless of whether the participant is a corporation, individual, partnership, tax-exempt entity, or any other type of entity.

The Administration's proposal also would confirm that for purposes of the list maintenance requirements of section 6112, the identity of any person is not privileged.

The proposal to amend the federal tax practitioner privilege would be effective with respect to communications made on or after the date of enactment. The proposal with respect to section 6112 would be effective as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
[47]--	--	--	--	--	--	--	--

[47] Included in combat abusive tax avoidance transactions

EXTEND THE STATUTE OF LIMITATIONS FOR REPORTABLE TRANSACTIONS WHERE A TAXPAYER FAILS TO DISCLOSE ON RETURN AS REQUIRED

Current Law

In general, taxes must be assessed within three years after the date on which a return is filed. If a taxpayer omits an item of gross income totaling more than 25 percent of the amount of gross income shown on the return, the statute of limitations is extended to six years. Taxes generally cannot be assessed or collected unless an assessment is made before the statute of limitations expires. Taxes may be assessed at any time if the taxpayer files a false or fraudulent return, or if the taxpayer fails to file a tax return.

Reasons for Change

Extending the statute of limitations for reportable transactions that are not disclosed properly will encourage taxpayers to make the required disclosures and will provide the IRS with the time necessary to examine these transactions.

Proposal

The Administration's proposal would extend the statute of limitations with respect to a reportable transaction if a taxpayer fails to disclose that transaction properly on a return. The statute of limitations with respect to any underpayment of tax arising from the reportable transaction will not expire until one year after the earlier of the date on which taxpayer provides the required disclosures regarding the reportable transaction or the date on which a material advisor satisfies its list maintenance requirements with respect to the taxpayer's transaction in response to an IRS request. This provision does not operate to shorten an otherwise applicable statute of limitation.

The proposal would be effective for taxable years with respect to which the period for assessing a deficiency had not expired on the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
[48]--	--	--	--	--	--	--	--

[48] Included in combat abusive tax avoidance transactions

REQUIRE INCREASED REPORTING FOR NONCASH CHARITABLE CONTRIBUTIONS

Current Law

In general, a taxpayer may claim a deduction for charitable contributions, subject to certain limitations based on the type of taxpayer, the property contributed and the type of donee organization. The amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution. In the case of contributions of inventory property and certain tangible personal property, the amount of the deduction generally is limited to lesser of the taxpayer's basis in the property (typically, cost) or fair market value.

In general, if the total deduction claimed for all contributed property is over $500, the taxpayer must file Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000.

Any individual, closely-held corporation, or personal service corporation claiming a charitable contribution deduction for a contribution of property (other than publicly-traded securities) valued at more than $5,000 ($10,000 in the case of nonpublicly traded stock) must obtain a qualified appraisal for the property contributed. C corporations (other than personal service corporations and closely-held corporations) are not required to obtain a qualified appraisal. In the case of donated art work valued at more than $20,000, a taxpayer that is required to obtain a qualified appraisal must attach a copy of the qualified appraisal itself to Form 8283.

Reasons for Change

Under current law, although an individual who contributes property to charity and claims a deduction of $5,001 must obtain a qualified appraisal, a C corporation (other than a closely-held corporation or a personal services corporation) that donates property to charity is not required to obtain a qualified appraisal, even if the corporation claims a deduction far in excess of $5,000. Requiring all taxpayers to obtain a qualified appraisal before claiming large charitable deductions for donated property (other than publicly traded stock) would reduce valuation abuses. In addition, requiring that a copy of the qualified appraisal be submitted to the IRS in the case of large deductions would assist the IRS in administering the law.

Proposal

Require all taxpayers to obtain a qualified appraisal for property (other than inventory property and publicly traded securities) donated to charity, if the deduction claimed exceeds $5,000. In addition, require the taxpayer to attach a copy of the qualified appraisal or an executive summary of the qualified appraisal to Form 8283 if the deduction claimed exceeds $500,000. Any executive summary attached to Form 8283 must be prepared by the qualified appraiser, and must contain a description of the donated property, the methodology used by the appraiser, a description of the critical facts relied upon, and such additional information as the Secretary may require by form or regulations. The limits would be indexed for inflation after December 31,

2003. The $5,000 limit would be indexed in $1,000 increments and the $500,000 requirement would be increased in $50,000 increments using the rounding rules in IRC Section 1(f).

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

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	49	31	32	33	34	179	367

CLARIFY THE CONSEQUENCES OF CHANGING THE BENFICIARY OF A QUALIFIED TUITION PROGRAM

Current Law

A section 529 program may be a prepaid tuition program or a savings program. Under either type of program, a contributor creates an account for the benefit of a particular designated beneficiary (DB) to provide for the DB's higher education expenses.

Income tax. Earnings in a section 529 account accumulate tax-free until a distribution is made. If a distribution is used to pay qualified higher education expenses (qualified expenses), the distribution is tax-free. If a distribution is not used to pay qualified expenses, the earnings portion of the distribution is subject to federal income tax, plus a 10 percent additional tax (subject to exceptions, including death, disability or receipt of a scholarship). A change in the DB of a section 529 account is not treated as a "distribution" for income tax purposes if the new DB is a member of the old DB's family.

Gift and Generation-Skipping Transfer (GST) Taxes on Contributions. A contribution to a section 529 account is treated as a completed gift of a present interest from the contributor to the DB. Therefore, contributions to a section 529 account qualify for the per-donee annual gift tax exclusion (currently $11,000); gifts sheltered by this exclusion are also exempt from GST tax. A contributor may contribute up to five times the per-donee annual gift tax exclusion to a section 529 account and, for gift and GST tax purposes, treat the contribution as having been made ratably over five years, beginning in the year the contribution is made.

Gift and GST Taxes on Distributions. Because a contribution to a section 529 account is treated as a completed gift, a distribution from a section 529 account generally is not subject to gift or GST tax. Those taxes may, however, apply to a change of DB. Gift or GST tax (or both) may be imposed if the new DB is in a generation below that of the former DB, or if the new DB is not a family member of the former DB.[49]

Estate Tax. Section 529 accounts generally are excluded from the gross estate of the contributor (unless the contributor is also the DB). If, however, the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years following the year of the contributor's death are includible in the contributor's gross estate. Amounts distributed on account of the death of the DB are includible in the DB's gross estate.

Reasons for Change

Current law regarding the transfer tax treatment of section 529 accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions. The law should be clarified to provide taxpayers with certainty as to the tax consequences of a transfer and to eliminate the inappropriate imposition of transfer taxes.

[49] A technical correction has been introduced to add the same family requirement to the statute, in accordance with the legislative history (H.R. Rep. 148 at 327-328).

In addition, the lack of any limits on who can be named a DB creates opportunities for the unintended and inappropriate use of section 529 plans. For example, taxpayers may seek to use section 529 accounts as retirement accounts, with all the tax benefits but none of the restrictions and requirements of qualified retirement accounts, or to avoid gift and GST taxes by changing the DB of existing section 529 accounts. This proposal would simplify the tax consequences of section 529 accounts, facilitate utilization of the accounts for educational purposes, and eliminate opportunities for abuse.

Proposal

As under current law, contributions to section 529 accounts would be treated as completed gifts to the DB, subject to applicable gift and GST taxes but eligible for the special five-year allocation rule. Also as under current law, a contributor's gross estate would include only the per-donee annual gift tax exclusion used for calendar years after the year of the contributor's death. The DB's gross estate would include only amounts (if any) paid to the DB's estate or pursuant to the DB's general power of appointment. No transfer taxes would be imposed on a change in DB.

Distributions used for the DB's qualified expenses would not trigger income tax, regard-less of the DB's identity. As under current law, the recipient of a distribution not used for qualified expenses (a nonqualified distribution) would be subject to income tax on the accrued income portion of the nonqualified distribution. The income portion of the first $50,000 in cumulative nonqualified distributions to a DB also would be subject to a 10 percent penalty unless the penalty would not have applied under current law (which exempts distributions made for reasons including the DB's death, disability or receipt of a scholarship).

In addition, each nonqualified distribution in excess of $50,000 (computed on a cumulative basis for each DB) would be subject to a new excise tax payable from the account, unless the distribution was made as a result of the DB's death, disability or receipt of a scholarship. The excise tax would eliminate the economic incentive to use a section 529 account for purposes other than that intended by the statute. The excise tax would be imposed at the rate of 35 percent on the first $100,000 of cumulative nonqualified distributions in excess of $50,000, and at the rate of 50 percent on cumulative nonqualified distributions in excess of $150,000. The excise tax would be withheld by the program administrator.

Only an individual under age 35 would be permitted to be the DB of a section 529 account. When the DB reaches age 35, either the account would be distributed to the DB or a new DB would be named. Similarly, if a DB dies, the account would be distributed to the DB's estate or a new DB would be named. The custodian of the account could have no beneficial interest in the account. The rules applicable to trusts contributing to section 529 accounts would be clarified, reporting requirements would be modified, and the Secretary would be granted broad regulatory authority to ensure that section 529 accounts are used in a manner consistent with Congressional intent.

The proposal generally would be effective for section 529 accounts (including prepaid tuition contracts) established after the date of enactment. Modified reporting requirements would apply

after the date of enactment to all section 529 accounts. Additional contributions to existing section 529 savings accounts would be prohibited unless those accounts elect to be governed by the new rules.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	7	12	13	13	17	62	194

TAX ADMINISTRATION AND UNEMPLOYMENT INSURANCE

Improve Tax Administration

IMPLEMENT IRS ADMINISTRATIVE REFORMS

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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
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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, first, 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 and, second, 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
--	--	--	--	--	--	--	--

Authorize partial-liability installment agreements

Current Law

The IRS may enter into an agreement to allow a 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 is unable to 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
0	52	47	46	47	49	241	505

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 specify 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 ensure 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'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 IRS Office of Appeals determinations made after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'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 (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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
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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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
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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, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
$'s in millions							
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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 arrangements, other than tax-qualified retirement plans, 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. Since the enactment of section 132 over 25 years ago, deferred compensation arrangements have become increasingly aggressive, in large part because of the prohibition on issuance of new guidance to deal with such aggressive

techniques. 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.

The proposal would be effective after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'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 November 2003, the IRS designated over $16.1 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 allowing PCAs to gather information that would enable the IRS to resolve the account administratively. PCAs would not be permitted to subcontract any taxpayer-contact (including the composition of written communications) or quality monitoring activities.

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, which is the same procedure for taxes collected by an IRS employee.

The proposal would be effective after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	0	47	151	190	153	541	1,531

INCREASE CONTINUOUS LEVY FOR CERTAIN FEDERAL PAYMENTS

Current Law

The Taxpayer Relief Act of 1997 authorizes the IRS to 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.

Reasons for Change

Many federal payments, such as salary, retirement, and benefit payments, are regularly recurring payments that can be continuously levied until the outstanding tax obligation is satisfied. Vendor payments (i.e., payments to vendors that provide goods or services to the Government), however, are not regularly recurring payments and present fewer opportunities for collection. Withholding more of the vendor payment will allow FMS to recoup a greater percentage of the outstanding tax debt.

Proposal

The Administration's proposal would increase the amount of a vendor payment that may be withheld under the FPLP to satisfy outstanding tax debts to 100 percent of the payment.

The proposal would be effective upon enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	10	18	19	20	20	87	202

STRENGTHEN THE FINANCIAL INTEGRITY OF THE UNEMPLOYMENT INSURANCE SYSTEM BY REDUCING TAX AVOIDANCE AND IMPROPER BENEFIT PAYMENTS

Current Law

The Federal Employment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. States also impose an unemployment tax on employers. Employers in States that meet certain federal requirements are allowed a credit against FUTA taxes of up to 5.4 percent, making the minimum net federal rate 0.8 percent. State Unemployment Insurance taxes are deposited into the State's Federal Unemployment Insurance Trust Fund and are used by the State to pay unemployment benefits.

Employer eligibility for the full FUTA rate reduction requires that the State assess unemployment tax rates on an employer in part according to the unemployment experience of that employer. This feature of State law is commonly known as "experience rating." Generally, the more unemployment benefits paid to former employees, the higher the State unemployment tax rate of the employer.

Reasons for Change

Some employers manipulate their experience rating, for example, by transferring employees to shell companies with little or no unemployment history to take advantage of the shell company's lower rate. Restricting the ability of employers to artificially lower their experience ratings will prevent tax avoidance in this area.

Some individuals continue to collect State unemployment benefits illegally after returning to work and therefore not remaining eligible for the benefits.

Proposal

The proposal would modify the requirements for State unemployment tax laws to deter schemes used by employers to manipulate experience rates so that they pay lower state taxes than they should based on their benefit experience. The proposal also allows the States access to the National Directory of New Hires, allowing them to more quickly determine those who are no longer eligible for benefit payments due to new employment. These changes would be effective beginning January 1, 2005.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	0	-2	108	142	120	368	-216

REAUTHORIZE FUNDING FOR THE HIGHWAY TRUST FUND

DEPOSIT FULL AMOUNT OF EXCISE TAX IMPOSED ON GASOHOL IN THE HIGHWAY TRUST FUND

Current Law

Excise taxes are imposed at various rates on highway motor fuels. In general, receipts from these taxes (except for the 0.1-cent-per-gallon Leaking Underground Storage Tank (LUST) Trust Fund excise tax) are transferred to the Highway Trust Fund. In the case of the tax on gasohol and other fuels containing specified percentages of ethanol or renewable source methanol, however, receipts attributable to a rate of 2.5 cents per gallon are retained in the general fund and only the remainder, less the amount transferred to the LUST Trust Fund, is transferred to the Highway Trust Fund.

Reasons for Change

The full amount of any excise tax on a highway motor fuel, less the amount dedicated to the LUST Trust Fund, is an appropriate source of funding for highway expenditures. The elimination of the rule providing for reduced transfers to the Highway Trust Fund in the case of gasohol and other fuels containing alcohol and renewable source methanol would provide needed additional funding for highway programs.

Proposal

All receipts from excise taxes on gasohol and other highway motor fuels containing ethanol or renewable source methanol, less the amount dedicated to the LUST Trust Fund, would be transferred to the Highway Trust Fund, effective for collections after September 30, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	0	648	666	691	699	2,694	6,443

IMPOSE ADDITIONAL REGISTRATION REQUIREMENTS ON THE TRANSFER OF TAX-EXEMPT FUEL BY PIPELINE, VESSEL, OR BARGE

Current Law

An excise tax is imposed on taxable fuel at a rate of 18.4 cents per gallon in the case of gasoline (other than aviation gasoline), 19.4 cents per gallon in the case of aviation gasoline, and 24.4 cents per gallon in the case of diesel fuel or kerosene. Tax is generally imposed on the removal of taxable fuel from a terminal. Tax is also imposed on the removal of taxable fuel from a refinery or the entry of taxable fuel into the United States, but an exemption applies if the fuel is transferred in bulk to a terminal or refinery and both the person removing or entering the fuel and the operator of the terminal or refinery receiving the bulk transfer are registered with the Internal Revenue Service. This exemption applies even if the bulk carrier transporting the fuel between the point of removal or entry and the registered terminal or refinery is not registered. Refiners, taxable fuel importers, terminal operators, and bulk carriers are required to register with the Internal Revenue Service. Persons that fail to register when required to do so are subject to a $50 penalty and, in the case of unregistered refiners, importers, and terminal operators, are unable to take advantage of the bulk transfer exemption. Registrants are not required to display proof of registration.

Reasons for Change

The current law rule permitting an exemption for bulk transport of untaxed fuel by unregistered carriers makes it more difficult for the IRS to track bulk transfers of taxable fuel between the refinery or point of entry into the country and the point of taxation and expands opportunities to divert the fuel to retailers or end users before tax is paid. Moreover, the absence of any requirement to display proof of registration makes it difficult for the IRS to determine whether a vessel or barge transporting taxable fuel is registered. In addition, the current law penalty for failure to register is not sufficient to ensure compliance.

Proposal

The proposal would limit the exemption for bulk transfers of taxable fuel to transfers by registered bulk carriers. In addition, vessel and barge operators transporting taxable fuel would also be required to display proof of registration in the manner prescribed by the IRS. New penalties would be imposed for failure to comply with registration and display of proof of registration requirements. The penalty for failure to register would be $1,000 per day and the penalty for failure to display proof of registration would be $500 per day. The proposal would apply to bulk transfers (in the case of limits on the exemption) and failures (in the case of the new penalties) occurring after October 31, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	76	93	96	91	87	443	747

REPEAL INSTALLMENT METHOD FOR PAYMENT OF HEAVY HIGHWAY VEHICLE USE TAX

Current Law

An annual tax is imposed on the use of heavy (at least 55,000 pounds) highway vehicles. The amount of tax increases from $100 (for a 55,000 pound vehicle) to $550 (for vehicles over 75,000 pounds). The tax year is July 1 through June 30 and the tax return is generally due on August 31 of the year to which it relates. A taxpayer may, however, elect to pay the tax in installments. The installment option generally permits payment of one quarter of the tax on each of the following dates: August 31, December 31, March 31, and June 30. States are required to obtain evidence, before issuing tags for a vehicle, that the use tax return has been filed and any tax due with the return has been paid.

Reasons for Change

The requirement that States obtain evidence of tax payment before issuing tags is the most cost-effective method of enforcing the heavy vehicle use tax. Under current law, however, tags can be issued if the tax due with the return (the first installment) has been paid even if the taxpayer is delinquent with respect to subsequent installments.

Proposal

The installment option would be eliminated for tax years beginning after June 30, 2004. Thus, heavy vehicle owners would be required to pay the entire tax with their returns and would be unable to obtain State tags without providing proof of full payment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
407	30	31	32	31	32	156	341

ALLOW TAX-EXEMPT FINANCING FOR PRIVATE HIGHWAY PROJECTS AND RAIL-TRUCK TRANSFER FACILITIES

Current law

Interest on State or local bonds is generally excluded from gross income. However, this exclusion generally does not apply to "private activity bonds." In general, a bond is a private activity bond if either: (1) more than ten percent of its proceeds is used for a private business use and more than ten percent of its debt service is secured by or payable from property used for a private business use; or (2) more than the lesser of $5 million or five percent of the proceeds is loaned to a nongovernmental person.

The Code contains several exceptions under which interest on private activity bonds is excluded from gross income. One category of tax-exempt private activity bonds is "exempt facility bonds." Facilities eligible for exempt facility bond financing include airports, docks and wharves, mass commuting facilities, water, sewage and solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas, local district heating or cooling facilities, qualified hazardous waste facilities, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities, and qualified public educational facilities. The volume of most tax-exempt private activity bonds is restricted by per-State limits. The annual volume limits are $75 per resident of the State or $225 million, if greater, and are indexed for inflation beginning in 2003.

Reasons for Change

Economic growth and productivity depend on a modern, well-connected national transportation network. Allowing a limited amount of tax-exempt private activity bonds to be issued for highway projects and surface freight transfer facilities would encourage private sector investment in these projects.

Proposal

Two new categories of exempt facility bonds would be authorized to finance highway facilities and surface freight transfer facilities. Issuance of the bonds would not be subject to the general private activity bond volume cap, but rather would be subject to a separate volume limitation of $15 billion in the aggregate. The Secretary of Transportation would allocate the $15 billion of authority among eligible projects.

Highway facilities eligible for financing under the program would consist of any surface transportation project eligible for federal assistance under title 23 of the United States Code, or any project for an international bridge or tunnel for which an international entity authorized under federal or State law is responsible. Surface freight transfer facilities would consist of facilities for the transfer of freight from truck to rail or rail to truck, including any temporary storage facilities directly related to those transfers. Examples of eligible surface freight transfer facilities would include cranes, loading docks and computer-controlled equipment that are integral to such freight transfers. Examples of non-qualifying facilities would include lodging, retail, industrial or manufacturing facilities.

The proposal would be effective for bonds issued after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-20	-49	-77	-94	-97	-337	-619

EXPIRING PROVISIONS

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. Generally, taxpayers are allowed to use most tax credits only to the extent their regular tax liability exceeds their tentative minimum tax. However, under provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), before 2011, the child tax credit, the adoption credit, and the new saver credit are not limited by the AMT, and the earned income tax credit and the additional child tax credit are not reduced by the amount of the AMT.

EGTRRA increased the alternative minimum tax (AMT) exemption amounts for taxable years 2001 through 2004, and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) further increased the exemptions for 2003 and 2004. For 2004, the exemption level is $40,250 for single and head of household filers, $58,000 for married taxpayers filing joint returns, and $29,000 for married taxpayers filing separate returns. EGTRRA and JGTRRA did not alter the AMT tax rates of 26 percent and 28 percent, the income level at which the 28 percent tax rate begins to apply, nor the income levels at which the AMT exemption is phased-out. After taxable year 2004, the exemption levels revert to their pre-EGTRRA levels of $33,750, $45,000, and $22,500, respectively.

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 did not apply to the child credit, earned income tax credit, the adoption credit, and the refundable portions of the child credit and the earned income credit, all of which were provided AMT relief through taxable year 2010 under EGTRRA.

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 JGTRRA 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.

Although these temporary changes will continue to ameliorate the AMT problem in the short-run, long-term change is needed. The Treasury Department has been directed to study the AMT with the goal of producing a long-term solution.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-86	-9,383	-13,881	0	0	0	-23,264	-23,264

PERMANENTLY EXTEND 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.

In addition, the principles that guided the development of the R&E credit statute in the past need to be reconsidered to determine whether modifications should be made to improve the credit's incentive effect. Ongoing uncertainty over the interpretation of the statutory requirements for credit eligibility has generated controversy between taxpayers and the IRS. Although administrative guidance has addressed much of this uncertainty, a number of the statutory requirements are inherently subjective. As a result, taxpayers often are not certain whether particular activities will qualify for the credit and taxpayer and IRS resources are needlessly consumed by controversy.

Further, in its current form the research credit results in disparate tax treatment of research-performing firms that is difficult to justify. Some taxpayers can receive large credits while others receive none for the same amount of qualifying research. The credit also can create a competitive disadvantage among firms in the same industry.

The complexity of the credit, and particularly the fixed base period, is an issue as well. Taxpayers, for example, who have sold or acquired other businesses face documentation and substantiation difficulties as time passes since the years comprising the fixed-base percentage (1984-1988). These difficulties relate to not only research spending but also gross receipts.

Proposal

The proposal would make the R&E credit permanent. The Administration is concerned that features of the R&E credit may limit its incentive effect. Consequently, the Treasury Department has been directed to study the credit and ways to improve its effectiveness. The Administration intends to work closely with the Congress to develop and enact the reforms that will rationalize the R&E credit and improve its incentive effect.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-672	-3,610	-5,187	-6,291	-7,129	-7,775	-29,992	-78,351

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 a stock company 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 the mutual life insurance industry has demutualized to a significant degree.

Proposal

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

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-85	-51	-48	-45	-43	-272	-471

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 of the Department of Education – only for purposes of establishing income contingent repayment amounts for certain student loans. This provision is scheduled to expire on December 31, 2004.

Reasons for Change

The Department of Education's student financial aid application requires applicants (and their parents) to provide information on adjusted gross income, earnings from employment, income tax liability, and type of tax return filed. Financial aid applications are processed by Department of Education contractors, and neither the Department of Education nor its contractors are permitted to receive return information from the IRS to verify the information on the financial aid applications. Allowing the Department of Education to use return information from the IRS to verify financial aid applications would significantly reduce fraud and error and allow financial aid to be directed to those students who are truly in need. In particular, statistical studies indicate that Pell Grant overpayments could be reduced by hundreds of millions of dollars each year if this type of verification were permitted.

Proposal

The Administration's proposal would permit the IRS to disclose to the Department of Education and its contractors identity information, filing status, adjusted gross income, earnings from employment, income tax liability, and type of tax return filed for purposes of verifying student financial aid applications, as well as establishing repayment amounts. The Department of Education and its contractors would remain subject to confidentiality restrictions and safeguards with respect to return information. The legislation would help to reduce fraud and error in student financial aid programs.

The expanded disclosure authority would apply to requests for disclosures made after the date of enactment.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
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EXTEND AND MODIFY WORK OPPORTUNITY TAX CREDIT AND 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.[50] 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 (SESAs) 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 requirement 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 (including individuals who begin work after December 31, 2003, and before the date of enactment).

[50] 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-12	-187	-268	-162	-86	-46	-749	-768

EXTEND THE DISTRICT OF COLUMBIA 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;[51] 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-46	-79	-37	-7	-9	-24	-156	-328

[51] Section 179 provides that, in place of depreciation, certain taxpayers, typically small businesses, may elect to deduct up to $100,000 of the cost of 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.

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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-1	-18	-17	0	0	0	-35	-35

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 is determined by reference to the adjusted applicable federal rate (AFR) published by the Internal Revenue Service. 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 the date of enactment, 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

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-2	-9	-15	-22	-28	-30	-104	-254

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. For contributions made in taxable years beginning before January 1, 2004, 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 provision does not apply to contributions made in 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 expired with respect to donations made in taxable years beginning after December 31, 2003, to apply to donations made in taxable years beginning before January 1, 2006.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-180	-46	0	0	0	-226	-226

EXTEND ALLOWANCE OF NET OPERATING LOSS OFFSET OF 100 PERCENT OF ALTERNATIVE MINIMUM TAXABLE INCOME

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

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
-1,326	-755	-101	203	154	129	-370	82

PERMANENTLY 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 December 31, 2004.

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 permanently 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							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	32	44	45	46	47	214	464

EXTEND PROVISIONS PERMITTING DISCLOSURE OF RETURN INFORMATION RELATING TO TERRORISM

Current Law

Current law permits disclosure by the IRS of return information to aid the investigation or response to terrorism in two situations. First, if a specified official 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. Second, 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 the agency's head (who in turn may disclose the information to agency officers and employees as necessary).

With respect to returns and return information that the taxpayer himself or herself filed, the IRS cannot make the disclosure to federal law enforcement or intelligence agency officers and employees without a court order indicating there is reasonable cause to believe the returns and return information at issue are relevant to the terrorist incident, threat or activity. If a federal law enforcement or intelligence agency seeks returns or return information, specified officials in the Department of Justice may apply for an ex parte court order. If the IRS wishes to apprise a federal law enforcement agency of a terrorist incident, threat, or activity, the IRS may apply for an ex parte court order and may make disclosures to the Department of Justice as necessary to prepare such application on behalf of the IRS.

Reasons for Change

This disclosure authority relating to terrorist activities expired on December 31, 2003. The Administration believes that extension would help provide continued support for investigations and responses relating to terrorism.

Proposal

The Administration proposes to extend this authority until December 31, 2004.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
--	--	--	--	--	--	--	--

EXTEND AUTHORITY TO ISSUE LIBERTY ZONE BONDS

Current law

Interest on State or local bonds is generally excluded from gross income. However, this exclusion generally does not apply to "private activity bonds." In general, a bond is a private activity bond if either: (1) more than ten percent of its proceeds is used for a private business use and more than ten percent of its debt service is secured by or payable from property used for a private business use; or (2) more than the lesser of $5 million or five percent of the proceeds is loaned to a nongovernmental person.

The Code contains several exceptions under which interest on private activity bonds is excluded from gross income. One category of tax-exempt private activity bonds is "exempt facility bonds." The volume of most tax-exempt private activity bonds is restricted by per-State limits. The annual volume limits are $75 per resident of the State or $225 million, if greater, and are indexed for inflation beginning in 2003.

Current law authorizes the issuance of $8 billion of qualified New York Liberty Bonds (Liberty Bonds). Liberty Bonds are generally treated as exempt facility bonds, but are not subject to the general private activity bond volume cap. A Liberty Bond is a bond issued as part of an issue if: (1) 95 percent or more of the net proceeds of the issue are to be used for qualified project costs; (2) the bond is issued by the State of New York or any political subdivision thereof; (3) the Governor of the State of New York or the Mayor of The City of New York designates the bond as a Liberty Bond; and (4) the bond is issued after March 9, 2002, and before January 1, 2005. Qualified project costs are the cost of acquisition, construction, reconstruction, and renovation of certain nonresidential real property, residential rental property and public utility property located in a specified area of New York City known as the "New York Liberty Zone." Qualified project costs also include the cost of acquisition, construction, reconstruction, and renovation of certain nonresidential real property located outside the New York Liberty Zone but within New York City, if the property is part of a project that consists of at least 100,000 square feet of usable office or other commercial space located in a single building or multiple adjacent buildings. No more than $2 billion of Liberty Bonds may be issued for property located outside the New York Liberty Zone.

Reasons for Change

Liberty Bonds provide assistance in the rebuilding and recovery of the area of New York City damaged or affected by the terrorist attack on September 11, 2001. Extending the authority to issue Liberty Bonds will assist in the planning and utilization of Liberty Bonds.

Proposal

Authority to issue Liberty Bonds would be extended through calendar year 2009.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
0	-8	-27	-45	-62	-79	-221	-616

EXTEND EXCISE TAX ON COAL AT CURRENT RATES

Current Law

An excise tax is imposed on coal at a rate of $1.10 per ton for coal from underground mines and $.55 per ton for coal from surface mines. In either case, the tax imposed with respect to a ton of coal may not exceed 4.4 percent of the amount for which it is sold by the producer. Receipts from the tax are deposited in the Black Lung Disability Trust Fund. Amounts in the Fund are used to pay compensation, medical, and survivor benefits to eligible miners and their survivors and to cover costs of program administration. Miners and survivors qualify for benefits from the Fund only if the miner's mine employment terminated before 1970 or no mine operator is liable for the payment of benefits. The Fund is also permitted to borrow from the general fund any amounts necessary to make authorized expenditures if excise tax receipts do not provide sufficient funding.

Reduced rates of tax apply after the earlier of December 31, 2013, or the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the general fund of the Treasury. The reduced rates of tax are $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines. In addition, the maximum tax imposed with respect to a ton of coal is reduced from 4.4 percent of the amount for which it is sold by the producer to 2 percent of that amount.

Reasons for Change

To reduce the duration of the general fund subsidy for black lung disability programs, excise tax rates on coal should remain at their current levels until all amounts borrowed from the general fund of the Treasury have been repaid with interest.

Proposal

The proposal would retain the excise tax on coal at the current rates until the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the general fund of the Treasury. After repayment of the Fund's debt, the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines would apply and the tax per ton of coal would be capped at 2 percent of the amount for which it is sold by the producer. The proposal would be effective for coal sales after December 31, 2003.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
($'s in millions)							
--	--	--	--	--	--	--	180

EXPAND PROTECTIONS FOR MEMBERS OF THE ARMED FORCES

Current Law

Under section 7508 of the Code, when a member of the Armed Forces is serving in a designated combat zone, the period spent in the combat zone, plus 180 days, is ignored in determining the timeliness of a variety of actions taken by either the IRS or the servicemember with respect to a federal tax liability. (Special rules apply to servicemembers who are hospitalized as a result of an injury sustained while serving in a combat zone.) Interest and penalties do not accrue during this period. Although the IRS is permitted to pursue certain assessment and collection actions during this time, the IRS suspends all assessment and collection actions against a member of the Armed Forces serving in a designated combat zone. Section 510 of the Servicemembers Civil Relief Act provides that if a servicemember's ability to pay a federal or state income tax liability arising before or during military service is materially affected by military service (whether or not in a combat zone), collection action with respect to the tax liability is deferred for the period of military service and up to 180 days after the servicemember's termination or release from military service. (The statute of limitation for the collection of tax affected by the deferral also is extended.) The deferral does not apply to certain Social Security taxes. No interest or penalties accrue on the unpaid income tax liability during the period of deferment.

Reasons for Change

Armed Forces reservists and National Guardsmen called to active duty often experience significant decreases in income and disruptions to their businesses. These disruptions increase the longer that these servicemembers remain on active duty. Current law provides these servicemembers additional time to address tax liabilities, including liabilities resulting from the disruption of being called to active duty, if the servicemember is in a designated combat zone or if the servicemember can demonstrate that his or her ability to pay an outstanding tax liability has been materially affected by military service. Even outside these situations, Armed Forces reservists and National Guardsmen called to active duty still experience significant personal and financial disruption and, in addition, may not be able to respond fully to tax assessment or collection actions. Extending existing protections will improve the morale and effectiveness of our Armed Forces while providing the IRS, state taxing authorities and servicemembers sufficient time to address outstanding tax liabilities.

Proposal

The Administration's proposal would extend the protections of section 7508 to all Armed Forces reservists and National Guardsmen called to active duty. Thus, the changes would result in the suspension of IRS assessment and collection action against Armed Forces reservists and National Guardsmen on active duty and would extend the time that these individuals would have to comply with their tax obligations, such as the filing of returns. While these individuals are on active duty, interest and penalties would not accrue on any federal tax liability owed. In addition, the proposal would extend the protections in Section 510 of the Servicemembers Civil Relief Act to suspend the assessment and collection of any state income tax liability for all servicemembers (including Armed Forces reservists and National Guardsmen) serving in a

designated combat zone and for all other Armed Forces reservists and National Guardsmen called to active duty.

The proposal would be effective upon enactment.

RESPOND TO FOREIGN SALES CORPORATION/EXTRATERRITORIAL INCOME DECISIONS

Current Law

The extraterritorial income exclusion (ETI) provisions provide a partial exemption from tax for income from certain foreign sales and leasing transactions. The ETI provisions 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, provide an illegal export subsidy and thus 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, which may be imposed at any time as long as the ETI provisions remain in the law. In December 2003, the EU Council of Foreign Affairs Ministers adopted a proposal providing for sanctions against U.S. exports to be phased in beginning in March 2004 if the United States has not come into compliance with the WTO decision by repealing the ETI provisions.

Reasons for Change

The ETI provisions must be repealed to comply with the WTO rulings regarding the FSC and ETI provisions. The ETI provisions should be replaced with tax law changes that preserve and enhance the global competitiveness of U.S.-based businesses and American workers. The Administration intends to work with the Congress on prompt enactment of legislation that satisfies the twin goals of honoring our WTO obligations and making changes to our tax law to promote the competitiveness of American manufacturers and other job creating sectors of the U.S. economy.

Changes to the tax law should reflect today's highly-competitive, highly-globalized, knowledge-driven economy. To ensure the ability of U.S. workers to achieve higher living standards, the tax laws should help, not hinder, the U.S. businesses that employ those workers to compete in markets around the world. The key to rising standards of living is focusing on the fundamentals for growth domestically and abroad.

Proposal

The ETI provisions would be repealed and replaced with changes to our tax law that increase the competitiveness of American manufacturers and other job creating sectors of the U.S. economy.

There are a number of changes to the tax laws that would improve the competitiveness of these vital contributors to the U.S. economy. Described below are some of the alternatives deserving consideration.

Among the proposals included in the Administration's FY 2005 budget are permanent extensions of both the R&E tax credit and increased expensing for small businesses as well as extension through 2005 of the waiver on the use of NOLs under the AMT. Extension of these provisions will provide certainty to job creating businesses and encourage investment and growth. In addition to extension, modifications to these provisions should be considered. The R&E tax

credit rules could be reformed and improved to make the credit easier for taxpayers to apply and easier for the IRS to administer. Giving taxpayers greater certainty regarding the availability of the credit would enhance its incentive effect and encourage more taxpayers to perform research in the United States. The NOL carryback period could be extended as well. Such a change would measure more accurately net income by providing appropriate tax relief for losses and increase the cash flow of taxpayers that incur losses by allowing a refund of taxes previously paid.

More broadly, a corporate income tax rate reduction would provide significant tax relief to American businesses and increase the attractiveness of the United States as a place to invest. A corporate rate cut would help to reduce the current tax burden on income from investment in corporate shares relative to income from other investments such as partnerships and bonds.

Alternative minimum tax reform would encourage greater business investment, reduce paperwork burdens, and provide relief for cyclical businesses, such as manufacturers. One potential AMT reform would be to conform depreciation methods under the AMT to the depreciation methods used for regular tax purposes. This would eliminate the AMT disincentive for new investment by allowing the regular tax depreciation allowances under AMT. This reform would benefit capital intensive businesses, encouraging them to continue to invest and grow. Another possible AMT reform would be repeal of the limitation on the use of foreign tax credits. The current-law limitation is inconsistent with the principle that foreign income should not be subject to double tax. Likewise, increasing and indexing the AMT exemption for small businesses would significantly reduce the number of small and medium sized businesses subject to the burdens of the AMT. Eliminating the AMT limitation on the use of NOLs would provide simplification and cash-flow benefits to taxpayers experiencing economic distress.

The depreciation rules could be re-examined, with particular consideration given to a shorter recovery period for nonresidential buildings. This would reduce the tax cost of such investments, including investments by manufacturing businesses, thereby stimulating aggregate investment and improving the neutrality of the tax system by reducing the tax bias that favors investment in equipment over structures. A shorter recovery period also would reduce the controversies that arise from the treatment of improvements and components.

Business tax rules could be simplified. The challenge for businesses trying to comply with the law - or the IRS trying to administer and enforce it - is enormous. In particular, small and medium-sized businesses often find this complexity to be nearly overwhelming. For example, the uniform capitalization rules are extremely complex and impose a significant compliance burden on small companies. Increasing the number of small businesses exempt from these rules would provide meaningful simplification. Another area of needed simplification, especially for small businesses, is the method for calculating tax on income received from long-term contracts.

The international tax rules are especially in need of simplification and rationalization. Relative to the tax systems of the United States' major trading partners, the U.S. international tax rules can impose significantly heavier burdens on domestically based companies, thereby hindering the ability of U.S. businesses to compete in today's global marketplace. The U.S. international tax rules are unique in their breadth and complexity. The complexity represents a significant

burden. One example is the interest expense allocation rules for foreign tax credit purposes. By understating foreign income and reducing the foreign tax credit limitation, these rules can deny U.S.-based companies the full ability to credit foreign taxes paid against U.S. tax liability, resulting in the double taxation that the foreign tax credit rules are intended to eliminate and reducing the competitiveness of the U.S. company relative to companies organized in other jurisdictions.

The Administration looks forward to working closely with the Congress on prompt enactment of legislation that brings our tax law into compliance with WTO rules with changes that will enhance the competitiveness of American businesses and the workers they employ.

Revenue Estimates */
FY 2005 Budget Proposals Affecting Receipts
(in millions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
Make Permanent The Tax Cuts Enacted in 2001 and 2003:													
Extend through 2010 certain provisions of the 2003 jobs and growth tax cut:													
Child tax credit 1/	---	-2,166	-13,195	-13,154	-13,070	-12,261	-7,139	---	---	---	---	-53,846	-60,985
Marriage penalty relief	---	-5,318	-6,634	-3,883	-1,850	-423	---	---	---	---	---	-18,108	-18,108
10-percent individual income tax rate bracket	---	-4,005	-5,981	-6,435	-4,036	-2,956	-3,017	-913	---	---	---	-23,413	-27,343
Total extend through 2010 certain provisions of the 2003 jobs and growth tax cut	---	-11,489	-25,810	-23,472	-18,956	-15,640	-10,156	-913	---	---	---	-95,367	-106,436
Permanently extend certain provisions of the 2001 tax cut and the 2003 jobs and growth tax cut:													
Dividends tax rate structure	---	498	486	485	642	-17,272	-252	-6,959	-15,741	-21,009	-22,158	-15,161	-81,280
Capital gains tax rate structure	---	---	---	---	-5,268	-7,366	-4,906	-6,193	-7,789	-9,023	-9,425	-12,634	-49,970
Expensing for small business	---	226	-3,336	-5,711	-4,102	-3,205	-2,612	-2,093	-1,614	-1,295	-1,056	-16,128	-24,798
Marginal individual income tax rate reductions	---	---	---	---	---	---	---	-68,943	-106,215	-109,163	-110,948	---	-395,269
Child tax credit 2/	---	---	---	---	---	---	1	-5,334	-32,003	-32,103	-32,250	---	-101,689
Marriage penalty relief 3/	---	---	---	---	---	---	---	-5,724	-11,472	-10,752	-10,154	---	-38,102
Education incentives	---	-11	-16	-22	-24	-37	-51	-903	-1,782	-1,896	-2,016	-110	-6,758
Repeal of estate and generation-skipping transfer taxes, and modification of gift taxes	---	-1,000	-1,609	-1,732	-1,977	-2,244	-2,092	-19,498	-46,482	-49,642	-53,835	-8,562	-180,111
Modifications of pension plans	---	---	---	---	---	---	---	-346	-468	-487	-503	---	-1,804
Other incentives for families and children	---	---	---	---	---	---	61	-260	-1,098	-1,112	-1,122	---	-3,531
Total permanently extend certain provisions of the 2001 tax cut and the 2003 jobs and growth tax cut	---	-287	-4,475	-6,980	-10,729	-30,124	-9,851	-116,253	-224,664	-236,482	-243,467	-52,595	-883,312
Total make permanent the tax cuts enacted in 2001 and 2003	---	-11,776	-30,285	-30,452	-29,685	-45,764	-20,007	-117,166	-224,664	-236,482	-243,467	-147,962	-989,748
Tax Incentives:													
Simplify and encourage saving:													
Expand tax-free savings opportunities	---	3,949	8,192	5,488	2,798	685	-735	-2,050	-3,806	-4,259	-4,704	21,112	5,558
Consolidate employer-based savings accounts	---	-214	-318	-337	-358	-380	-406	-1,591	-2,478	-2,684	-2,997	-1,607	-11,763
Establish Individual Development Accounts (IDAs)	---	-134	-286	-326	-300	-255	-91	3	3	3	3	-1,301	-1,380
Total simplify and encourage saving	---	3,601	7,588	4,825	2,140	50	-1,232	-3,638	-6,281	-6,940	-7,698	18,204	-7,585
Invest in health care:													
Provide refundable tax credit for the purchase of health insurance 4/	---	-106	-5,177	-6,100	-7,242	-7,765	-8,047	-8,609	-8,889	-9,045	-9,075	-26,390	-70,055
Provide an above-the-line deduction for high deductible insurance premiums	---	-173	-1,764	-2,014	-2,292	-2,501	-2,729	-2,994	-3,209	-3,431	-3,668	-8,744	-24,775
Provide an above-the-line deduction for long-term care insurance premiums	---	-68	-489	-805	-1,572	-2,435	-2,648	-2,878	-3,152	-3,574	-3,807	-5,369	-21,428
Provide an additional personal exemption to home care-givers of family members	---	-71	-460	-398	-398	-415	-414	-422	-410	-392	-379	-1,742	-3,759
Allow the orphan drug tax credit for certain pre-designation expenses	---	---	---	---	---	---	---	---	---	---	---	-1	-2
Clarify the Health Coverage Tax Credit	*No revenue effect*												
Total invest in health care	---	-418	-7,890	-9,317	-11,504	-13,116	-13,838	-14,903	-15,660	-16,442	-16,929	-42,245	-120,017
Provide incentives for charitable giving:													
Provide charitable contribution deduction for nonitemizers	---	-1,248	-1,103	-1,111	-1,144	-1,173	-1,206	-1,245	-1,251	-1,248	-1,307	-5,779	-12,036
Permit tax-free withdrawals from IRAs for charitable contributions	-68	-450	-341	-327	-330	-329	-319	-337	-358	-354	-353	-1,777	-3,498
Expand and increase the enhanced charitable deduction for contributions of food inventory	---	-42	-87	-96	-106	-116	-127	-140	-154	-169	-187	-447	-1,224

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
Reform excise tax based on investment income of private foundations	---	-133	-83	-84	-86	-90	-96	-100	-106	-112	-119	-476	-1,009
Modify tax on unrelated business taxable income of charitable remainder trusts	---	-8	-5	-6	-6	-6	-7	-7	-7	-8	-8	-31	-68
Modify basis adjustment to stock of S corporations contributing appreciated property	---	-21	-13	-15	-18	-21	-24	-27	-30	-34	-36	-88	-239
Repeal the $150 million limitation on qualified 501(c)(3) bonds	---	-8	-10	-11	-10	-10	-10	-10	-9	-8	-8	-49	-94
Repeal certain restrictions on the use of qualified 501(c)(3) bonds for residential rental property	---	-5	-6	-12	-18	-25	-32	-40	-47	-54	-60	-66	-299
Total provide incentives for charitable giving	-68	-1,915	-1,648	-1,662	-1,718	-1,770	-1,821	-1,906	-1,962	-1,987	-2,078	-8,713	-18,467
Strengthen education:													
Extend, increase and expand the above-the-line deduction for qualified out-of-pocket classroom expenses	-23	-229	-240	-249	-260	-263	-266	-270	-274	-278	-282	-1,241	-2,611
Encourage telecommuting:													
Exclude from income the value of employer-provided computers, software and peripherals	---	-27	-45	-43	-48	-55	-65	-76	-89	-103	-117	-218	-668
Increase housing opportunities:													
Provide tax credit for developers of affordable single-family housing	---	-7	-81	-327	-776	-1,352	-1,972	-2,545	-2,947	-3,154	-3,248	-2,543	-16,409
Protect the environment:													
Permanently extend expensing of brownfields remediation costs	-178	-243	-212	-201	-191	-181	-176	-171	-166	-161	-156	-1,028	-1,858
Exclude 50 percent of gains from the sale of property for conservation purposes	---	-45	-88	-101	-58	---	---	---	---	---	---	-292	-292
Total protect the environment	-178	-288	-300	-302	-249	-181	-176	-171	-166	-161	-156	-1,320	-2,150
Increase energy production and promote energy conservation:													
Extend and modify the tax credit for producing electricity from certain sources	---	-401	-337	-305	-278	-139	-141	-143	-146	-148	-137	-1,460	-2,175
Provide tax credit for residential solar energy systems	---	-12	-11	-17	-23	-10	---	---	---	---	---	-73	-73
Modify treatment of nuclear decommissioning funds	---	-193	-147	-154	-162	-169	-175	-182	-188	-195	-202	-825	-1,767
Provide tax credit for purchase of certain hybrid and fuel cell vehicles	---	-79	-223	-376	-556	-542	-15	-43	-77	-121	-179	-1,776	-2,211
Provide tax credit for energy produced from landfill gas	---	-34	-67	-91	-104	-117	-130	-138	-56	---	---	-413	-737
Provide tax credit for combined heat and power property	---	-154	-107	-64	-62	-13	21	15	10	5	---	-400	-349
Extend excise tax exemption (credit) for ethanol	*No revenue effect*												
Permit electric utilities to defer gain from sales of electric transmission property	-11	-475	-615	-532	-227	100	355	512	540	507	196	-1,749	361
Modify tax treatment of certain income of electric co-operatives	---	-14	-20	-21	-22	-23	-24	-26	-27	-28	-30	-100	-235
Total increase energy production and promote energy conservation	-11	-1,362	-1,527	-1,560	-1,434	-913	-109	-5	56	20	-352	-6,796	-7,186
Total tax incentives	-280	-645	-4,143	-8,635	-13,849	-17,600	-19,479	-23,514	-27,323	-29,045	-30,860	-44,872	-175,093
Simplify the Tax Laws for Families:													
Establish uniform definition of a qualifying child 5/	---	-38	-70	-65	-56	-46	-40	-39	-37	-39	-45	-275	-475
Simplify adoption tax benefits	---	-4	-39	-40	-42	-43	-45	-47	-49	-50	-52	-168	-411
Eliminate household maintenance test for head of household filing status	---	-123	-297	-284	-285	-281	-273	-264	-261	-250	-237	-1,270	-2,555
Reduce computational complexity of refundable child tax credit 6/	---	---	181	183	185	187	189	193	198	201	205	736	1,722

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
Simplify EITC eligibility requirements regarding filing status, presence of children, investment income, and work and immigrant status 7/	---	504	-167	-165	-151	-167	-157	-175	-154	-152	-131	-146	-915
Simplify the taxation of dependents	---	-11	-25	-20	-25	-43	-48	-59	-82	-89	-96	-124	-498
Consolidate rules for lifetime learning credit, Hope credit and education expense deductions, and simplify other higher education provisions	---	-19	-94	-311	-294	-282	-279	-289	-344	-326	-320	-1,000	-2,558
Allow annual reporting and payment of combined State and Federal unemployment insurance taxes by employers of household employees	---	-20	-1	-1	-1	-1	-1	-2	-1	-1	-1	-24	-30
Simplify taxation of capital gains on collectibles, small business stock and other assets	---	-4	5	11	-1	-17	-13	-10	-7	-1	2	-6	-35
Total simplify the tax laws for families	---	285	-507	-692	-670	-693	-667	-692	-737	-707	-675	-2,277	-5,755
Strengthen the Employer Based Pension System:													
Ensure fair treatment of older workers in cash balance conversions and protect defined benefit plans	---	---	---	---	---	---	339	512	510	507	505	---	2,373
Improve the accuracy of pension liability measures	8,537	12,297	7,340	3,042	-1,586	-5,467	-7,322	-6,569	-5,781	-5,833	-5,990	15,626	-15,869
Total strengthen the employer based pension system	8,537	12,297	7,340	3,042	-1,586	-5,467	-6,983	-6,057	-5,271	-5,326	-5,485	15,626	-13,496
Close Loopholes and Improve Tax Compliance:													
Combat abusive tax avoidance transactions	---	46	63	85	113	128	130	128	127	126	125	435	1,071
Limit related party interest deductions	---	-51	93	146	203	265	333	407	486	571	663	656	3,116
Modify qualification rules for tax-exempt property casualty insurance companies	---	67	114	116	119	121	124	127	129	132	135	537	1,184
Increase penalties for false or fraudulent statements made to promote abusive tax shelters	*Included in combat abusive tax avoidance transactions*												
Prevent abusive overvaluations on donations of patents and other intellectual property	---	432	270	273	277	287	302	317	333	349	367	1,539	3,207
Prevent overvaluations and other abuses in charitable donations of used vehicles	---	158	102	105	108	112	115	119	122	126	130	585	1,197
Reform the tax treatment for leasing transactions with tax-indifferent parties	340	1,591	2,712	3,285	3,565	3,766	3,833	3,799	3,683	3,581	3,570	14,919	33,385
Ensure foreign subsidiaries of U.S. companies cannot inappropriately avoid U.S. tax on foreign earnings invested in U.S. property through use of the exception for bank deposits	---	24	21	22	22	23	23	24	24	25	26	112	234
Modify tax rules for individuals who give up U.S. citizenship or green card status	1	23	20	22	24	25	27	29	32	34	36	114	272
Expand tax shelter exception for federal practitioner privilege	*Included in combat abusive tax avoidance transactions*												
Extend the statute of limitations for reportable transactions where a taxpayer fails to disclose on return as required	*Included in combat abusive tax avoidance transactions*												
Require increased reporting for noncash charitable contributions	---	49	31	32	33	34	35	36	38	39	40	179	367
Clarify the consequences of changing the beneficiary of a qualified tuition program	---	7	12	13	13	17	23	12	30	33	34	62	194
Total close loopholes and improve tax compliance	341	2,346	3,438	4,099	4,477	4,778	4,945	4,998	5,004	5,016	5,126	19,138	44,227
Tax Administration, Unemployment Insurance and Other:													
Improve tax administration:													
Implement IRS administrative reforms	---	52	47	46	47	49	50	51	53	54	56	241	505
Initiate IRS cost saving measures	*No revenue effect*												

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
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					*No revenue effect*								
Permit private collection agencies to engage in specific, limited activities to support IRS collection efforts	---	---	47	151	190	153	166	181	197	214	232	541	1,531
Increase continuous levy for certain Federal payments	---	10	18	19	20	20	21	22	23	24	25	87	202
Total improve tax administration	---	62	112	216	257	222	237	254	273	292	313	869	2,238
Strengthen financial integrity of unemployment insurance:													
Strengthen the financial integrity of the unemployment insurance system by reducing tax avoidance and improper benefit payments 8/	---	---	-2	108	142	120	101	-790	335	101	-331	368	-216
Other proposals:													
Increase Indian gaming activity fees 9/	---	---	4	4	5	5	5	5	5	5	5	18	43
Total other proposals	---	---	4	4	5	5	5	5	5	5	5	18	43
Total tax administration, unemployment insurance and other	---	62	114	328	404	347	343	-531	613	398	-13	1,255	2,065
Reauthorize Funding for the Highway Trust Fund:													
Deposit full amount of excise tax imposed on gasohol in the Highway Trust Fund 8/	---	---	648	666	681	699	716	732	750	766	785	2,694	6,443
Impose additional registration requirements on the transfer of tax-exempt fuel by pipeline, vessel, or barge 8/	---	76	93	96	91	87	80	71	62	52	39	443	747
Repeal installment method for payment of heavy highway vehicle use tax 8/	407	30	31	32	31	32	34	36	38	38	39	156	341
Allow tax-exempt financing for private highway projects and rail-truck transfer facilities	---	-20	-49	-77	-94	-97	-100	-94	-61	-21	-6	-337	-619
Total reauthorize funding for the highway trust fund	407	86	723	717	709	721	730	745	789	835	857	2,956	6,912
Expiring Provisions:													
Extend minimum tax relief for individuals	-86	-9,383	-13,881	---	---	---	---	---	---	---	---	-23,264	-23,264
Permanently extend research & experimentation (R&E) tax credit	-672	-3,610	-5,187	-6,291	-7,129	-7,775	-8,347	-8,961	-9,619	-10,330	-11,102	-29,992	-78,351
Repeal the disallowance of certain deductions of mutual life insurance companies	---	-85	-51	-48	-45	-43	-42	-41	-39	-38	-39	-272	-471
Permanently extend and expand disclosure of tax return information for administration of student loans					*No revenue effect*								
Extend and modify work opportunity tax credit and welfare-to-work tax credit	-12	-187	-268	-162	-86	-46	-16	-3	---	---	---	-749	-768
Extend the District of Columbia enterprise zone	-46	-79	-37	-7	-9	-24	-42	-40	-33	-30	-27	-156	-328
Extend the first-time homebuyer credit for the District of Columbia	-1	-18	-17	---	---	---	---	---	---	---	---	-35	-35
Extend authority to issue Qualified Zone Academy Bonds	-2	-9	-15	-22	-28	-30	-30	-30	-30	-30	-30	-104	-254
Extend deduction for corporate donations of computer technology	---	-180	-46	---	---	---	---	---	---	---	---	-226	-226
Extend allowance of net operating loss offset of 100 percent of alternative minimum taxable income	-1,326	-755	-101	203	154	129	111	100	89	80	72	-370	82
Permanently extend IRS user fees	---	32	44	45	46	47	48	49	50	51	52	214	464
Extend provisions permitting IRS to disclose return information relating to terrorist activity					*No revenue effect*								

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
Extend provision permitting disclosure of information relating to terrorist activities upon request of federal law enforcement or intelligence agency						*No revenue effect*							
Extend abandoned mine reclamation fees 9/	---	239	245	252	256	262	252	257	260	262	265	1,254	2,550
Extend authority to issue Liberty Zone Bonds	---	-8	-27	-45	-62	-79	-88	-84	-79	-74	-70	-221	-616
Extend excise tax on coal at current rates 8/	---	---	---	---	---	---	---	---	---	---	180	---	180
Total extend other expiring provisions	-2,145	-14,043	-19,341	-6,075	-6,903	-7,559	-8,154	-8,753	-9,401	-10,109	-10,699	-53,921	-101,037
Promote Trade:													
Implement free trade agreements with Morocco, Australia and Central American countries 8/ 9/	---	-389	-583	-675	-749	-831	-897	-967	-1,009	-1,073	-1,132	-3,227	-8,305
Total budget proposals	6,860	-11,777	-43,244	-38,343	-47,852	-72,068	-50,169	-151,937	-261,999	-276,493	-286,348	-213,284	-1,240,230

*/ Estimates for several provisions differ from estimates included in Table 16-3 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.

1/ Affects both receipts and outlays. The outlay effect is $4,265 million for 2006, $4,131 million for 2007, $4,003 million for 2008, $3,936 million for 2009 $4,568 million for 2010, $16,335 million for 2005-2009 and $18,906 million for 2005-2014.

2/ Affects both receipts and outlays. The outlay effect is $9,887 million for 2012, $9,599 million for 2013, $9,417 million for 2014 and $28,903 million for 2005-2014.

3/ Affects both receipts and outlays. The outlay effect is -$320 million for 2011, $2,006 million for 2012, $1,997 million for 2013, $1,993 for 2014 and $5,676 million for 2005-2014.

4/ Affects both receipts and outlays. The outlay effect is $82 million for 2005, $3,760 million for 2006, $5,041 million for 2007, $6,388 million for 2008, $7,133 million for 2009, $7,814 million for 2010, $8,401million for 2011, $8,698 million for 2012, $8,920 million for 2013, $9,091 million for 2014, $22,404 million for 2005-2009 and $65,355 million for 2005-2014.

5/ Affects both receipts and outlays. The outlay effect is $36 million for 2006, $36 million for 2007, $36 million for 2008, $37 million for 2009, $37 million for 2010, $37 million for 2011, $38 million for 2012, $38 million for 2013, $38 million for 2014, $145 million for 2005-2009 and $333 million for 2005-2014.

6/ Affects both receipts and outlays. The outlay effect is -$181million for 2006, -$183 million for 2007, -$185 million for 2008, -$187 million for 2009, -$189 million for 2010, -$191 million for 2011, -$193 million for 2012, -$195 million for 2013, -$197 million for 2014, -$736 million for 2005-2009 and -$1,701million for 2005-2014.

7/ Affects both receipts and outlays. The outlay effect is -$440 million for 2005, $131 million for 2006, $130 million for 2007, $119 million for 2008, $134 million for 2009, $123 million for 2010, $140 million for 2011, $112 million for 2012, $107 million for 2013, $87 for 2014, $74 million for 2005-2009 and $643 million for 2005-2014.

8/ Net of income offsets.

9/ The proposal affects receipts and is included in the FY 2005 Budget, but is not described in these General Explanations.