97-854 E

CRS Report for Congress

Received through the CRS Web

The Taxpayer Relief Act of 1997: An Overview

Updated October 17, 1997

David L. Brumbaugh
Specialist in Public Finance
Economics Division

The Taxpayer Relief Act of 1997: An Overview

Summary

On July 31, the House and Senate both passed the Taxpayer Relief Act of 1997 (H.R. 2014). The President signed the measure on August 5; it became P.L. 105-34. The bill provides a tax cut of modest size in the aggregate that consists of a variety of measures applying to particular types of taxpayers, income, and activities. Its most prominent features are a $500 per-child tax credit ($400 for 1998), a cut for capital gains, several tax benefits for education, reduction of estate taxes, and expansion of Individual Retirement Accounts. Along with these tax reductions, the bill contains a number of revenue raising provisions that offset part (but substantially less than all) of the revenue loss from the bill's tax cuts. The largest revenue raiser is modification and extension of a set of aviation-related excise taxes that were scheduled to expire. An associated budget reconciliation Act (the Balanced Budget Act of 1997; P.L. 105-33) that focuses on spending rather than outlays contains an increase in excise taxes on cigarettes and tobacco products.

Contents

Tax Cut Provisions 4
- Child Tax Credit 4
- Capital Gains 4
- Individual Retirement Accounts IRAs 5
- Education Tax Benefits 6
- Estate and Gift Tax Provisions 7
- Alternative Minimum Tax 8
- Expiring Tax Provisions 9
- District of Columbia Tax Incentives 9
- Welfare-to-Work Credit 10
- Other Tax Reduction Provisions 11

Revenue Increase Provisions 11
- Aviation Taxes 11
- Tobacco Taxes (in the Balanced Budget Act) 12
- Other Revenue-Raising Provisions 12

Line-Item Veto 12

Technical Corrections 13

Revenue Effects 14

Additional CRS Reports and Issue Briefs 17

List of Tables

Table 1. Revenue Effects of the Taxpayer Relief Act 15

The Taxpayer Relief Act of 1997: An Overview

In general, the Taxpayer Relief Act provides a modest aggregate tax reduction consisting of several major tax cut measures aimed at particular categories of taxpayers, income, and activities (e.g., families with children, capital gains, saving and investment, education) along with a host of smaller, more narrow provisions. The bill also contains a number of revenue raising items that fall far short of offsetting the revenue loss from the bill's tax cuts; the bulk of the revenue increases are from aviation-related excise taxes. (A substantial amount of revenue is also raised by an increase in tobacco taxes contained in an associated budget reconciliation Act, H.R. 2015.) The aggregate net revenue effect of P.L. 105-34 and associated provisions in H.R. 2015 is estimated to be a reduction of $95.3 billion over 5 years and $275.4 billion over 10 years.

The origins of the Taxpayer Relief Act can be traced to the first days of the 104th Congress, when, in early 1995, House Republicans introduced the "Contract with America" as legislation. A number of tax cuts formed the centerpiece of the Contract — a per-child tax credit, a broad reduction for capital gains, reduction of estate taxes, and liberalized Individual Retirement Accounts — and were passed by Congress in November 1995, as part of the Balanced Budget Act of 1995. However, President Clinton vetoed the bill because of concerns that it favored upper-income individuals and would increase the federal budget deficit. The Taxpayer Relief Act that was passed by Congress in July 1997, and subsequently signed into law by President Clinton, contains tax cuts quite similar to the principal provisions of the 1995 Contract, including the child credit and tax cuts for capital gains, more generous IRA rules, and reduced estate taxes. The recent bill also contains a number of tax benefits for education and a host of more narrow changes in the tax law.

In part, the intention of congressional supporters of the 1997 Act was simply to reduce taxes as part of an effort to reduce the size of government and the aggregate tax burden.[1] The bill was not passed as a remedy for an economic emergency; at the time of enactment, the economy was at full employment and had been growing without interruption since early 1991. Indeed, economic performance had been such that the revenue-reducing tax cut was passed in the context of a plan to balance the federal budget by the year 2002.[2] But in targeting the tax reductions to certain

---

[1]See, for example, the remarks of Representative Bill Archer, Chairman of the House Ways and Means Committee in the *Congressional Record*, June 26, 1997. P. H4668.

[2]Economic growth resulted in a downwards revision of the Congressional Budget Office's projections for budget deficits. According to press reports, the smaller-than-expected budget deficits helped form the basis of a budget agreement between Congress and the Administration (continued...)

activities and types of income, the bill was also intended to stimulate and encourage activities that were argued to be economically or socially beneficial. The tax cut for capital gains and liberalized IRA rules, for example, were supported on the grounds they would stimulate saving and investment; the tax benefits for education were designed to encourage investment in education.

In terms of its aggregate size, the revenue reduction estimated to result from the Taxpayer Relief Act might be termed modest, or even small. The revenue loss from the bill is expected to grow over time because a number of its important provisions are phased in and because a number of its provisions are "back loaded," or structured so as to postpone their revenue loss. Still, by its fifth year, when many of its phased-in tax cuts have become fully effective, the Act is expected to reduce revenue by only slightly over 1%; by its tenth year the Act is expected to reduce revenue by slightly less than 2%. In either case, the reduction is small compared to the size of the economy; the estimated revenue loss in either the fifth or tenth year is less than one-half of one percent of projected Gross Domestic Product.[3] The reduction is also small compared to that of the 1981 Economic Recovery Tax Act (ERTA), whose scheduled tax reductions were expected to reduce tax revenues by an estimated 21% by the Act's fifth year. (Some of the 1981 Act's tax cuts were rescinded by subsequent legislation before they were fully implemented.) Of course, the targeted nature of the 1997 Act's provisions hold forth the possibility that while the aggregate cut may not be large, the bill may have significant effects for some groups or sectors of the economy — for example, families with children or individuals with capital gains income.

If the aggregate size of the Act is modest or small, its shape can be described as irregular rather than even, or across-the-board. As suggested above, the measure provides reductions applicable to particular activities, groups, and types of income rather than across-the-board tax reductions that might, for example, be produced by a general reduction in statutory rates. The bill consists of 20 titles that can separated into 3 groups: the first 10 titles contain the measure's principal tax cuts: a $500 per-child tax credit, tax benefits for education, expansion of IRAs, reduced capital gains taxes, reduced estate and gift taxes, extension of several expiring tax provisions, and numerous other more narrow reductions. The second part of the bill is its Title X, and contains the Act's revenue-raising provisions. There are a large number of these, but most are small and narrowly applicable. The principal revenue-raising item is extension and modification of a set of aviation-related excise taxes. (As noted above, an additional revenue raising item is the increase in tobacco excise taxes that is provided by H.R. 2015 — the reconciliation bill generally devoted to outlays.) The third part of the bill contains its final 10 titles, which are generally devoted to a host of narrow provisions, most of which the bill terms "simplification" measures.

---

[2](...continued)
that included a tax cut. *Tax Notes*, May 19, 1997. P. 883.

[3]CRS calculations based on revenue loss estimates by the Joint Tax Committee (*Estimated Budget Effects of the Conference Agreement on the Revenue Provisions of HR 2014, the "Taxpayer Relief Act of 1997,"* JCX-39-91, July 30, 1997), and baseline revenue and GDP estimates by the Congressional Budget Office (*The Economic and Budget Outlook: Fiscal years 1998 - 2007*, January, 1997.)

The shape of the bill can also be described in terms of its impact on equity. Economists generally distinguish between two types of equity — horizontal equity, which compares taxes paid by persons with equal incomes — and vertical equity, which compares taxes paid by people at different income levels. The impact of the bill on horizontal equity is relatively straightforward: its tax reduction for individuals in certain specific circumstances likely reduces the tax system's horizontal equity.

The effect of the bill on vertical equity has been hotly debated throughout the bill's path through Congress. The bill's proponents have argued that it favors middle-income taxpayers, while others — including the administration — criticized early versions of the bill for favoring upper-income people. In part, the differing views were a result of different methods of analyzing the bill and presenting conclusions. A study by CRS, however, concluded that conventional economic analysis suggests the separate House and Senate versions of the bill favored upper income individuals.[4] The final conference committee version of the Act was modified from the House and Senate versions to reflect a compromise with the Clinton administration. However, the essential elements of the House and Senate bill remain in the final Act.

Before turning to a closer look at the provisions of P.L. 105-34, it helps to put it in perspective by comparing its policy direction to the two landmark tax acts of the 1980s — the Economic Recovery Tax Act of 1981 (mentioned above) and the Tax Reform Act of 1986. The 1981 and 1986 Acts are generally recognized to have been guided by opposing views of the appropriate role of tax policy in the economy. The 1981 Act was, in part, based on a belief in the economic efficacy of targeted tax incentives — that judiciously selected and aimed tax reductions could enhance economic performance. For example, one of ERTA's most prominent measures was expansion of Individual Retirement Accounts, which were designed to stimulate saving. Only 5 years later, however, the Tax Reform Act of 1986 was designed to promote economic efficiency, equity, and simplicity. It was based, in part, on the notion that the economy functions best when tax-induced distortions of behavior are minimized; both this idea and the Act's goal of horizontal equity led to an emphasis in its provisions on reducing differences in how different activities and types of income are taxed.

While a full assessment of the Taxpayer Relief Act is, of course, premature at this point, it is clear that the measure is closer to ERTA's guiding principles than those of the Tax Reform Act. For example, the 1997 Act's liberalized IRAs build on the IRA concept that was expanded with ERTA. And both the Taxpayer Relief Act's IRA provisions and its cut for capital gains are based on the same belief in the efficacy of tax incentives for saving and investment that underlay much of the 1981 Act.

In contrast to the 1986 Tax Reform Act, there is little doubt that the 1997 Act complicates the tax system. (See, for example, the discussion below of the Act's multiple alternative education tax benefits and its various holding periods and rates for capital gains. And, as noted above, the 1997 Act likely reduces horizontal equity. We note, however, an important difference between the 1997 Act and both ERTA

---

[4]U.S. Library of Congress. Congressional Research Service. *Distributional Effects of the Proposed Tax Cut*. CRS Report 97-669 E, by Jane G. Gravelle. Washington, 1997. P. 1.

and the Tax Reform Act. The 1997 Act is substantially smaller than ERTA; and while the net revenue impact of the 1986 Act was quite small, it was substantially broader in scope than the Taxpayer Relief Act.

For further information, see: *Distributional Effects of the Proposed Tax Cut*. CRS Report 97-669 E, by Jane G. Gravelle; *Federal Tax Policy, 1980-89*: *A Brief Overview*. CRS Report 90-612, by David L. Brumbaugh. For a detailed explanation of the bill, see: U.S. Congress. Conference Committees. *Taxpayer Relief Act of 1997.* Conference report to accompany HR 2014. H. Rept. 105-220. 105th Cong., 1st. Sess. Washington, U.S. Govt. Print. Off. 1997. 809 p. For brief descriptions of the House and Senate versions of H.R. 2014, see: *Taxes and FY1998 Budget Reconciliation: Highlights of the House, Senate, and Conference Bills*. CRS Report 97-614 E, by David Brumbaugh and Gregg Esenwein.

Tax Cut Provisions

Child Tax Credit

The bill provides a $500 ($400 for tax year 1998) per-child tax credit for children under 17. The credit is phased out for taxpayers with Adjusted Gross Income (AGI) in excess of $110,000 in the case of joint returns, $55,000 for married persons filing separately, and $75,000 in the case of single returns. The phaseout thresholds are not indexed for inflation; the phaseout reduces the credit by $50 for each $1,000 above the phaseout threshold.

For families with 1 or 2 children, the credit is calculated before the family calculates its Earned Income Tax Credit (EITC) — an important ordering rule, since the EITC is refundable and will therefore not be reduced even if the child credit offsets some or all of the family's pre-credit tax liability. For families with 3 or more children, the child credit itself is refundable, but it and the EITC together cannot exceed the employee's share of FICA taxes the taxpayer has paid.

The credit is effective for tax years beginning in 1998. Again, however, the credit for 1998 is $400, rising to $500 in subsequent years..

For further information, see: *Child Tax Credits: Comparison of Proposals for Low-Income Taxpayers.* CRS Report 97-687 E, by Gregg Esenwein and Jack Taylor; and *Federal Income Tax Treatment of the Family*. CRS Report 91-694 RCO, by Jane G. Gravelle.

Capital Gains

The bill contains several provisions that reduce taxes on capital gains. First, it provides a set of reduced tax rates for capital gains in general. Under both the Act and prior law, a graduated set of 5 tax rates apply to ordinary income: 15%, 28%, 31%, 36%, and 39.6%. Under prior law a maximum tax rate of 28% applied to capital gains from the sale of assets held more than 1 year. The Act applies two reduced maximum rates: a maximum 10% rate to gains that would be taxed at 15%

if ordinary income rates applied; and a maximum 20% rate to gains that would be subject to rates higher than 15% if they were ordinary income. The lower rates apply to sales after May 6, 1997; for amounts taken into account before July 29, 1997, the lower rates apply only to assets held longer than 1 year (as did the 28% rate under prior law). Beginning on July 29, however, the new reduced rates apply only to assets held longer than 18 months. Prior law's maximum rate of 28% continues to apply to assets held longer than 1 year but not longer than 18 months. The 28% rate also continues to apply to gains from the sale of collectibles.

Beginning in 2001, the Act reduces its 20% and 10% maximum rates to 18% and 8% for assets held more than 5 years. In the case of the 18% rate (but not the 8% rate), the holding period can only begin with tax year 2001.

Instead of the 28% rate or either the 20%/10% or 18%/8% structure, a separate "recapture" rate applies to real estate. Under its terms, gain from the sale of depreciable real estate is generally subject to a maximum 25% rate to the extent of prior depreciation deductions that have been claimed on the property.

The Act also replaces prior law's benefits for gains from the sale of homes. Under prior law, taxpayers could exclude gain from the sale of a principal residence from taxation if the gain was reinvested in another home ("rolled over"). Also, taxpayers 55 or over were allowed a one-time exclusion of gain from the sale of a home, up to a maximum of $125,000. The Act provides, instead, a $250,000 exclusion of gain from the sale of a principal residence ($500,000 for joint returns) that is not contingent on rollovers and is not restricted to those over 55. The exclusion can be used for one sale every 2 years. It is available for sales made after May 6, 1997.

As described below, the Act's provisions for allocating capital losses among the various classes of capital gains income contained a certain amount of vagueness. Legislation clarifying the rules has been introduced as technical corrections legislation, in H.R. 2645.

For further information, see: *Capital Gains Tax Issues and Proposals*. CRS Report 96-769 E, by Jane G. Gravelle; *The Revenue Cost of Capital Gains Cuts*. CRS Report 97-559 E, by Jane G. Gravelle; and *Depreciation Recapture and the Taxation of Capital Gains.* CRS Report 97-609 E, by Gregg A. Esenwein.

Individual Retirement Accounts IRAs

The Act has a number of different provisions related to IRAs, including both liberalization of rules and restrictions governing the type of IRAs allowed under prior law; and creation of 2 new types of IRAs — so-called "back loaded" IRAs and education IRAs.

Under prior law, individuals not participating in employer-sponsored pension plans were permitted to deduct up to $2,000 in contributions to IRAs annually ($4,000 in the case of couples). In the case of individuals who participate in retirement plans themselves or whose spouses participate, the deduction was phased out beginning at AGIs of $25,000 ($40,000 for couples). The 1997 Act gradually

doubles the phase-out threshold for deductions to $50,000 by the year 2005 ($80,000 for couples). The Act also provides that persons will not be disqualified from deducting IRA contributions if they, themselves, do not participate in a pension, but their spouse does. Finally, withdrawals from IRAs prior to age 59 ½ are subject to a 10% early withdrawal tax; the 1997 Act permits penalty free withdrawals of funds used to pay higher education expenses or first-time home purchases.

The 1997 creates a new type of "back loaded" IRA — so called because contributions are not deductible, but qualified withdrawals are not taxed. If a person expects to have the same tax rate upon retirement as when contributions are made, the back loaded IRAs (designated "Roth IRAs" by the Act) deliver the same magnitude of tax benefit, per dollar of contribution, as deductible IRAs. Somewhat different rules, however, apply to back-loaded IRAs: allowable contributions to them are phased out at higher AGIs than is the deduction — between $95,000 and $110,000 for singles (between $150,000 and $160,000 for couples). In addition, contributions to all an individual's IRAs (i.e., deductible and back-loaded IRAs combined) are not permitted to exceed $2,000 in one year. As with deductible IRAs, penalty free withdrawals are permitted under the Act for first-time home purchases or higher education expenses.

The Act provides that funds can generally be shifted from prior-law type IRAs to Roth IRAs. The shifted amounts are included in taxable income ratably over 4 years (assuming they would be taxed if they were normal distributions), and the 10% penalty tax on early withdrawals would not apply. As noted below in the section on technical corrections, the Act inadvertently permits Roth IRAs to be used as a means of withdrawing funds from prior-law type IRAs without incurring the early withdrawal tax. Technical corrections legislation (H.R. 2645) has been introduced that would rule out this unintended benefit.

Finally, the Act permits taxpayers to establish education IRAs; as with back-loaded IRAs, qualified withdrawals — in this case, for post-secondary education expenses that include tuition, books, and room and board — are not taxed but contributions are not deductible. Annual contributions are limited to $500 per beneficiary (i.e., per student); allowable contributions are phased out for AGIs between $95,000 and $110,000 ($150,000 and $160,000 for joint returns).

For further information: *Individual Retirement Accounts (IRAs) and Related Proposals.* CRS Report 97-629, by Jane G. Gravelle; and *Individual Retirement Accounts (IRAs): Legislative Issues in the 105th Congress*. CRS Report 96-20 EPW, by James Storey.

Education Tax Benefits

The Taxpayer Relief Act contains a number of different tax benefits related to education; the most prominent are three interrelated provisions: two tax credits the bill terms the "Hope Scholarship" credit and the "Lifetime Learning" credit; and the education IRAs described in the preceding section. The provisions are interrelated in that for a particular taxable year, the taxpayer can only use one of the 3 benefits with respect to the education expenses of a particular student. (However, a taxpayer

— for example, a parent — can claim the benefit of one provision for one dependent student and use a different benefit for another student.)

The Hope Scholarship credit applies to educational expenses incurred for the first 2 years of a student's postsecondary education; it is further limited to 2 taxable years. The credit is 100% (per student and per year) of the first $1,000 of qualified educational expenses and 50% of the next $1,000, for a maximum annual credit of $1,500. The credit can be used for expenses incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The student in question must be at least half-time; qualified expenses include tuition and fees required for enrollment, but not books, room, or board. The credit is phased out for AGIs between $40,000 and $50,000 ($80,000 and $100,000 in the case of joint returns). It is effective beginning January 1, 1998.

The Lifetime Learning credit is 20% of qualified expenses; it is calculated on a per-taxpayer rather than a per-student basis as with the Hope credit. Unlike the Hope credit, it can be claimed for an unlimited number of years rather than just 2 years. For expenses paid after June 30, 1998 (when the credit is first effective) and before January 1, 2003, the credit applies to a maximum of $5,000 of expenses, for a maximum credit of $1,000 per taxpayer return. Beginning in 2003, the credit applies to a maximum of $10,000 of qualified expenses, for a maximum credit of $2,000. As with the Hope credit, the Lifetime credit only applies to tuition and fees, and is phased out over the same income ranges.

As noted above, withdrawals from education IRAs that are used to pay education expenses — including, in this case, room and board and books as well as tuition — are generally excluded from taxable income under the Act. Again, however, only one of the 3 benefits — the 2 credits and exclusion of education IRA withdrawals — can be claimed for a particular students. However, the same taxpayer can claim different tax benefits for different students.

Among the other tax benefits in the bill that are related to education are: a deduction for interest on student loans; extension of the exclusion for employer-provided undergraduate education expenses (until June 1, 2000), a phased-in increase in the cap on tax-exempt state and local bonds that can finance private, charitable (501(c)(3)) organizations; an augmented deduction for corporate charitable contributions of computer equipment and technology.

For additional information, see: *Tax Benefits for Education in the Budget Reconciliation Legislation*. CRS Report 97-650 EPW, by Bob Lyke; and *Tax Subsidies for Education: An Analysis of the Administration's Proposal*. CRS Report 97-581 E, by Jane G. Gravelle and Dennis Zimmerman.

Estate and Gift Tax Provisions

The Act reduces the estate and gift tax in a number of ways, but by far the largest reduction is a phased-in increase of the unified credit, which provides an effective tax exemption for transfers below a certain level. Under prior law, the credit provided an effective exemption of $600,000; the 1997 Act gradually increases the exemption to $1,000,000, as follows: $625,000 in 1998; $650,000 in 1999; $675,000

in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1,000,000 in 2006 and thereafter.

The Act provides an additional benefit for estates comprised of family-owned businesses. Under its terms, up to $1,000,000 of a qualified estate can be excluded from tax. The special family business exclusion is in addition to the general unified credit. However, the effective combined exemption from the exclusion and the unified credit is not permitted to exceed $1.3 million. Note also that the special exclusion is fully effective beginning in 1998, while the increase in the unified credit is phased in, as described above. Thus, the relative advantage for family-business estates gradually diminishes to $300,000 as the unified credit increases to $1,000,000.

Among the other estate tax reductions are: indexation of several existing provisions that have the effect of reducing estate and gift taxes (e.g., the limit on "special use" valuation); reduction of estate tax for land subject to a conservation easement; and reduction of the interest rate applicable to installment payments of estate tax.

As noted below, the phase in of the unified credit's increase unintentionally reduces the total tax cut provided to family business estates. This unintended interaction is corrected by technical corrections legislation in HR 2645.

For further information, see: *Estate Tax Issues and Proposals: An Overview*. CRS Report 97-610 E, by Salvatore Lazzari.

Alternative Minimum Tax

In general, the Alternative Minimum Tax (AMT) functions much like a parallel tax system; it has its own rules for determining taxable income (more stringent than those of the regular tax), and it has its own rates (lower than those of the regular tax). A person or corporation pays either their AMT or their regular tax, whichever is greater. The Act reduces the AMT in several ways.

First, the Act reduces (but does not repeal entirely) the so-called "adjustment" for depreciation, which under prior law was the most important aggregate difference between AMT taxable income and that of the regular tax. Under prior law, the AMT required depreciation deductions to be claimed at a slower rate than did the regular tax. It did this through two mechanisms: by specifying longer recovery periods for assets (i.e., depreciation deductions for different assets must be spread over more years under the AMT than under the regular tax); and by requiring the use of slower depreciation methods (meaning that a smaller share of an asset's cost can be deducted in the first years of the recovery period). The 1997 Act conforms AMT recovery periods (but not depreciation methods) with those of the regular tax, effective for assets placed in service after 1998.

The Act contains two additional AMT reductions. First, it repeals the AMT, beginning in 1998, for corporations whose gross receipts averaged less than $5 million in 1995, 1996, and 1997. Such corporations continue to be exempt from the AMT in any tax year as long as their average gross receipts for the preceding 3 years does not exceed $7.5 million. Second, the Act repeals the AMT adjustment for installment

accounting in the case of farmers. The conference agreement on the Act did not include an earlier proposal to increase the AMT exemption for individuals.

For additional information, see: *The Corporate Alternative Minimum Tax: Economic Implications of the Taxpayer Relief Act of 1997.* CRS Report 97-814 E, by Gary Guenther.

Expiring Tax Provisions

The income tax contains a number of tax benefits that are temporary — that is, they apply for limited periods of time, and then are scheduled to expire. In the past, the temporary terms of most of the provisions have expired on a number of occasions, but Congress has acted to extend the provisions for additional temporary periods, or make them permanent. The temporary provisions (sometimes called "extenders") include: the exclusion for employer provided educational assistance; the research and experimentation tax credit; the work opportunity tax credit; the orphan drug tax credit; and the special treatment of contributions of stock to private foundations. The Taxpayer Relief Act extends each of the temporary provisions as follows:

Exclusion for employer provided education assistance	through May 31, 2000
Research and experimentation tax credit	through June 30, 1998
Work opportunity tax credit	through June 30, 1998
Orphan drug tax credit	made permanent
Contributions of stock to private foundations	through June 30, 1998

For additional information, see: *Expiring Tax Provisions*. Issue Brief 95064, by Sylvia Morrison; *The Research and Experimentation Tax Credit*. Issue Brief 92039, by Gary Guenther; *Gifts of Appreciated Stock to Private Foundations*. CRS Report 97-501 E, by Louis Alan Talley; and *The Work Opportunity Tax Credit and the 105th Congress*. CRS Report 97-540 E, by Linda Levine.

District of Columbia Tax Incentives

The Act provides two federal tax benefits for the District of Columbia. One provision creates a new, expanded "DC Enterprise Zone" in the District and associates a capital gains exemption with the new zone; the second provision provides a tax credit for buyers of homes in the District. The DC Enterprise Zone encompasses a broader area than prior law's enterprise community; the Act's new Zone include several specified census tracts that are economically distressed as well as any District tract that registers a poverty rate of 20% or greater. Like prior law's enterprise communities, businesses in the DC Enterprise Zone qualify for a 20% wage credit, an additional $20,000 expensing benefit for equipment investment, and relaxed rules for tax-exempt private activity bonds. In addition, a 0% capital gains rate

applies to sales of qualified assets in the DC Enterprise Zone and any District census tract whose poverty rate is no less than 10%. Qualified assets include stock or partnership shares in a business within the qualified area, as well as tangible assets of the businesses.

The homebuyer tax credit is $5,000 and applies to the first-time purchase of either a new or a previously owned principal residence. The credit is phased out for individuals with Adjusted Gross Incomes between $70,000 and $90,000 ($110,000 and $130,000 for joint filers).

For further information, see: *District of Columbia Revitalization: Legislation Enacted by the 105th Congress*, Coordinated by Eugene Boyd. CRS Report 97-766 GOV..

Welfare-to-Work Credit

The Act authorizes the Welfare-to-Work Credit (WWTC) that provides a tax credit to firms that hire members of families that are relatively long-time recipients of benefits under the Aid to Families with Dependent Children or its successor, Temporary Assistance to Needy Families, program. The new credit is in addition to the existing Work Opportunity Tax Credit (WOTC) which also provides a tax credit for employment of members of families who have received public assistance benefits along with members of certain other targeted groups. However, the requirements and rates of the new credit are somewhat different; the new credit is generally targeted at longer-term recipients and recipients whose benefits have ceased because of time limitations. Further, an employer cannot claim both the WOTC and the WWTC for wages paid to the same person.

The WWTC's rate is somewhat higher than that of the WOTC. The new credit is 35% of the first $10,000 of an eligible recipient's first year of employment and 50% of the first $10,000 earned in the employee's second year. WOTC's rate is generally 25% of the first $6,000 earned by an employee retained for 120-399 hours and 40% of the first $6,000 earned by an employee retained for a longer period. The new WWTC applies to persons who received benefits for the 18 months ending on the date of hire; persons who have received benefits for an 18-month period after the date of enactment and hired no more than 2 years after the end of the 18-month period; and members of families whose eligibility for public benefits ended because of time limitations on the benefits and hired not more than 2 years after the date of benefit cessation. For its part, the WOTC requires eligible employees to have received benefits for 9 months during the 18-month period ending on the hiring date.

The WWTC is effective from January 1, 1998 through April 30, 1999. Based on the Joint Tax Committee's revenue loss estimate of $106 million (FY1998 - FY2007), expectations appear low concerning the credit's ability to generate much job creation for welfare recipients.

For further information, see: *The Welfare-to-Work Tax Credit: A Fact Sheet*, by Linda Levine. CRS Report 97-784 E.

Other Tax Reduction Provisions

The Act contains numerous additional tax cut provisions which are generally smaller in magnitude or narrower in their scope than those outlined above. Here is a partial list:

Repeal of the excise tax on diesel fuel used in recreational motorboats;
Reduced excise tax on hard cider;
Delay of penalties related to the Electronic Federal Tax Payment System;
Liberalized rules for home office deductions;
Phased-in increase (to 100% by 2007) of for the deduction of health insurance costs of self-employed persons;
Increased business meal deduction for certain transportation workers (truck drivers, pilots, and others);
Expensing of environmental remediation costs ("brownfields");
Temporary suspension of income limitations for percentage depletion on marginal wells;
Designation of additional empowerment zones and modification of empowerment zone and enterprise community criteria; and
Income averaging for farmers.

Revenue Increase Provisions

The Taxpayer Relief Act contains a large number of revenue-raising provisions. Most of the measures are quite narrow and small, but a few — notably the extension of and modification of aviation-related excise taxes — raise a significant amount of revenue. In addition, the reconciliation act related to spending — the Balanced Budget Act of 1997 — contains a substantial increase in the excise tax on tobacco. The total revenue estimated to be raised by the revenue increase provisions in both Acts is $56.4 billion over 5 years and $126.0 billion over 10 years. This offsets roughly one-third of the gross revenue loss from the act's revenue-losing provisions.

Aviation Taxes

The single largest revenue-raiser by far is the extension and modification of the aviation related excise taxes that are paid into the Airport and Airway Trust Fund. The taxes were scheduled under prior law to expire on October 1, 1997. The Act's extension is for 10 years and are estimated to account for almost two-thirds of the estimated revenue gain from the two reconciliation Acts.

The Taxpayer Relief Act modified the structure of the aviation taxes by gradually reducing prior law's 10% tax on all domestic tickets to 7.5% while phasing in a $3.00 tax on each flight segment (i.e., a single takeoff and landing). The new flight segment tax is more akin to a user fee than the ad valorem ticket tax, and tended to be favored by larger airlines. In addition, the Act increases prior law's $6 international departure tax to $12, and extends it to international arrivals. The act also applies the air passenger tax to purchases of the right to award frequent flyer miles. Prior law's 6.25% cargo tax, 15 cent tax on aviation gasoline, 17.5 cent tax on jet fuel were extended without modification. The 4.3 cent tax on aviation gasoline and jet fuel that

previously was deposited in the Treasury Department's general fund was shifted to the Airport and Airway Trust Fund.

For further information, see: *Aviation Taxes and the Airport and Airway Trust Fund.* CRS Report 97-657 E, by John W. Fischer.

Tobacco Taxes (in the Balanced Budget Act)

The Balanced Budget Act of 1997 (the BBA; P.L. 105-33) was also approved by Congress in late July; like the Taxpayer Relief Act, it was a budget reconciliation measure, but contained primarily provisions related to entitlement spending (e.g., food stamps, Medicare, and Medicaid). An exception was a substantial increase in the federal excise tax on cigarettes and related products, which was included in the spending act rather than the tax act. Beginning in 2000, the BBA provides a 10-cent per pack increase in the federal excise tax on cigarettes, thus raising the tax from current law's 24 cents per pack to 34 cents; the act increases taxes on other tobacco products — for example, cigars, chewing tobacco, snuff, and pipe tobacco — by the same proportion. Effective in 2002, the BBA increases the tax by an additional 5 cents per pack, and increases the other tobacco taxes proportionally.

The conference agreement on the Taxpayer Relief Act provided that the payments by firms under future federal legislation implementing the June 1997 tobacco industry settlement would be reduced by the amount of the Act's increase in excise taxes. In September, however, legislation repealing the provision was being considered by Congress. The Senate voted to repeal the measure on September 10.

Other Revenue-Raising Provisions

The act contains numerous other revenue-raising provisions, generally more narrow in scope and raising smaller amounts of revenue that the aviation and tobacco excise tax provisions. The act separates the provisions into the following categories: financial products; corporate organizations, reorganizations and other corporate provisions; administrative provisions; provisions relating to tax-exempt organizations; foreign provisions; pension and employee benefit provisions; and other revenue-increase provisions.

Line-Item Veto

On August 11, 1997, President Clinton vetoed 2 tax items contained in The Taxpayer Relief Act and one contained in the Balanced Budget Act under authority provided to him by the Line Item Veto Act of 1996 (P.L. 104-130). Under the Act, the President is permitted to exercise a line-item veto with respect to tax benefits that apply to only a limited number of taxpayers.

The Line Item Veto Act requires the Joint Tax Committee to identify items eligible for the veto; in the case of the Taxpayer Relief Act, the Committee identified 79 such items. The 2 provisions in the tax bill vetoed by the President were: a measure granting special treatment to foreign-source financial services income; and favorable treatment of stock sales to certain farmer's cooperatives. The vetoed item

contained in the Balanced Budget Act concerned Medicaid-related taxes imposed by States.

For further information, see: *Citations to Provisions in 1997 Reconciliation Acts Canceled under the Line Item Veto Act. CRS Report 97-773 GOV,* by Robert Keith; and *Item Veto and Expanded Impoundment Proposals. CRS Issue Brief 89148,* by Virginia McMurtry.

Technical Corrections

The need for legislation to make technical corrections in the Taxpayer Relief Act became apparent shortly after the bill was enacted.[5] On October 9, the House Ways and Means Committee approved H.R. 2645, which contained over 40 provisions generally aimed at clarifying vague parts of the Taxpayer Relief Act and ruling out unintended consequences. The three most prominent changes were: closing of an unintended benefit for conversion of amounts into Roth IRAs; clarification of rules for the netting of capital losses; and modification of certain estate and gift tax provisions.

As described above in the section on IRAs, the Taxpayer Relief Act contemplated an easing of the normal rules for taxing IRA withdrawals in the case of amounts withdrawn from an IRA established under prior law rules and reinvested ("rolled over") into a Roth IRA. Under the bill, the normal 10% tax on early withdrawals did not apply to amounts rolled into Roth IRAs, and withdrawals that would ordinarily be immediately included in taxable income would be included only over 4 years. The Act apparently unintentionally permitted amounts rolled into Roth IRAs to be subsequently withdrawn without incurring the 10% early-withdrawal tax. HR 2645 contains provisions that foreclose this possibility.

HR 2645 also clarifies the "netting" rules for capital gains that determine which of the Taxpayer Relief Act's various categories of capital gains are offset by which capital losses. Gain from assets subject to the 28% rate (in the 28% "basket" as it is sometimes called) is grouped with losses in the same basket -- losses from assets that would be subject to the 28% rate if they had produced a gain instead of a loss. For example, a loss from an asset held more than a year and less than 18 months that is sold after July 18, 1997, is deducted under the bill from gain subject to the 28% rate. In addition, short-term capital loss and long-term capital losses that have been carried forward are deducted from gains in the 28% basket. If a taxpayer registers a net capital loss from assets in the 28% basket, the loss is deducted from gains subject to the next highest rate — the 25% rate that applies to gains subject to depreciation recapture. If a capital loss still remains, it is deducted from gains subject to the next highest rate, and so forth.[6]

---

[5]See, for example, Efforts Under Way to Fix Technical Errors, Restore Vetoed Line Items. *Tax Notes*. Sept. 22, 1997. P. 1515-6.

[6]The provisions in the technical corrections bill follow the rules proposed in a letter from conressional leaders to the Treasury Department on September 29. BNA *Daily Tax Report*, October 10, 1997. P. GG-1.

The correction to the estate tax provisions concerns the interaction between the Act's gradual increase in the unified credit and its extra exemption for family businesses. As noted above, the Taxpayer Relief Act scheduled a gradual increase in the effective exemption provided by the unified credit from its current level of $600,000 to $1,000,000 by the year 2006. Estates comprised of family businesses have the option, under the Act, of claiming an additional exemption equal to the difference between $1,300,000 and the exemption afforded by the unified credit. (The total exemption from the family business provision and the unified credit cannot, in other words, exceed $1,300,000.) The unanticipated interaction arises because the exemption afforded by the unified credit comes "off the bottom" while the family business exemption comes "off the top." That is, the unified credit's exemption is calculated so that it effectively offsets the first taxable dollars of an estate that are subject to relatively low tax rates under the estate tax's graduated rate structure. In contrast, the family business exemption offsets the last taxable dollars of an estate that are subject to the highest estate tax rates. As a consequence, as the unified credit increase is phased in and the family business exemption consequently declines (because of the $1,300,000 cap), taxes on estates comprised of family businesses can gradually increase: an "off the top" exemption amount is exchanged for an "off the bottom" one. HR 2645 would rectify this by providing that the family business exemption would be reduced by the dollar amount of the unified credit — not by the increase in the credit's effective exemption. Thus, the maximum total tax savings from the credit and family exemption combined would remain constant as the credit's increase is phased in.

Revenue Effects

The following estimates of the revenue effects of the Taxpayer Relief Act and the Balanced Budget Act are by the Joint Committee on Taxation and were published in the conference report of the Taxpayer Relief Act (*Taxpayer Relief Act of 1997.* Conference Report to Accompany H.Rept. 105-220. pp. 776-808.)

Table 1. Revenue Effects of the Taxpayer Relief Act

REVENUE LOSING PROVISIONS:	Effective	1997-02	1997-07
$500 tax credit for children under 17 ($400 in 1998), $75,000/110,000 AGI phaseout.	1/1/98	-$85.0	-$183.4
Tax credits for education expenses	1/1/98	-31.6	-76.0
Expansion of State-sponsored tuition and savings programs to include room and board	1/1/98	-0.5	-1.5
Student loan interest deduction	1/1/98	-0.7	-2.4
Education IRAs	1/1/98	-3.9	-14.2
Penalty-free withdrawals from IRAs for education expenses	1/1/98	-0.8	-1.7
Extension of exclusion for undergraduate employer-provided education assistance (through 5/31/00)	12/31/96	-1.2	-1.2
Other Education-related Tax Incentives	varies	-0.7	-1.8
Education tax incentives subtotal:		-39.4	-98.8
Expanded IRAs	1/1/98	-1.8	-20.2
Capital gains tax changes: 20/10% rate for assets held 18 month; 18%/8% rate for assets held 5 years after 2000; exclusion of gain from sale of reesidence ; various other provisions.	varies	+.1	-21.2
Savings incentives subtotal:		-1.7	-41.4
Alternative minimum tax provisions: eliminate AMT for small corporations; conform AMT depreciation class lives to regular tax; reverse IRS position on installment sales by farmers.	varies	-8.2	-20.0
Estate and gift tax reductions, including increase of unified tax credit to $1 million over 10 years; $1.3 million exclusion for family-owned businesses.	varies	-6.4	-34.5
Expiring tax provisions: extend research tax credit, contributions of appreciated stocks, work opportunity tax credit through 6/30/98; make orphan drug tax credit permanent. See also extension of employer education assistance listed above.	Generally 6/1/97, but 10/1/97 for WOTC	-2.9	-3.1
District of Columbia tax incentives	Varies	-0.7	-1.2
Welfare to work tax credits	1/1/98	-0.1	-0.1
Miscellaneous revenue losing tax provisions	varies	-4.9	-12.3

REVENUE RAISING PROVISIONS			
Extend and modify Airport Trust Fund excise taxes	varies	+33.4	+80.2
Other excise tax provisions	varies	+1.5	+3.2
Provisions related to financial products	varies	+2.2	+3.8
Provisions related to corporate reorganizations and other corporate provisions	varies	+1.7	+2.8
Administrative provisions	varies	+2.3	+4.8
Provisions Relating to Tax-Exempt Organizations	varies	+0.5	+1.2
Foreign Provisions	varies	+0.4	+1.0
Pension and Employee Benefit Provisions	varies	+0.0	+0.3
Other revenue raising provisions	varies	+9.2	+12.1
Revenue raising provisions subtotal:		+51.2	+109.4
Simplification and Other Foreign Provisions	varies	-1.1	-4.1
OTHER SIMPLIFICATION PROVISIONS:			
Individual and business simplification	varies	-0.5	-1.2
Estate and gift tax simplification	varies	a/	a/
Excise tax simplification	varies	-0.1	-0.3
Pension simplification	varies	-0.3	-0.8
Other simplification provisions subtotal:		-0.9	-2.3
Trade: GSP extension through 6/20/98	6/1/97	-0.4	-0.4
Net revenue effect of tax reconciliation bill (HR 2014)		-100.4	-292.0
Revenue provisions in spending reconciliation bill (HR 2015), including tobacco excise tax increase		+5.2	+16.7
Total revenue effect of reconciliation bills		-95.3	-275.4

a/ Revenue loss of less than $50 million.

SOURCE: Joint Committee on Taxation

Additional CRS Reports and Issue Briefs

CRS Report 97-657 E. *Aviation taxes and the Airport and Airway Trust Fund*, by John W. Fischer.

CRS Issue Brief 97024. *The Budget for fiscal year 1998*, by Philip D. Winters.

CRS Report 96-769 E. *Capital gains issues and proposals: an overview*, by Jane G. Gravelle.

CRS Report 97-860 E. *The Child Tax Credit*, by Gregg Esenwein.

CRS Report 97-687 E. *Child tax credits: comparison of proposals for low-income taxpayers*, by Gregg A. Esenwein and Jack H. Taylor.

CRS Report 97-773 GOV. *Citations to provisions in 1997 reconciliation acts cancelled under the Line Item Veto Act*, by Robert Keith.

CRS Report 96-311 E. *The corporate alternative minimum tax: likely effects of repealing it*, by Gary Guenther.

CRS Report 97-308 E. *Corporate "tax welfare,"* by Jane G. Gravelle.

CRS Report 97-628 E. *Corporate-owned life insurance: tax issues*, by Jack Taylor.

CRS Report 95-455 S. *Distributional effects of tax provisions in the Contract with America as reported by the Ways and Means Committee*, by Jane G. Gravelle.

CRS Report 97-766 GOV. *District of Columbia revitalization: legislation enacted by the 105th Congress*, coordinated by Eugene P. Boyd.

CRS Report 97-609 E. *Depreciation recapture and the taxation of capital gains income*, by Gregg A. Esenwein.

CRS Report 97-669 E. *Distributional effects of the proposed tax cut*, by Jane G. Gravelle

CRS Report 97-546 E. *The Electronic federal tax payments system: background and proposals*, by Jack Taylor.

CRS Report 97-610 E. *Estate tax issues and proposals: an overview*, by Salvatore Lazzari.

CRS Issue Brief 95064. *Expiring tax provisions*, by Sylvia Morrison.

CRS Report 97-333 E. *Family tax credit proposals in the 105th Congress*, by Gregg A. Esenwein.

CRS Report 97-929 E. *Farm tax issues in the 105th Congress*, by Jack Taylor.

CRS Report 97-128 E. *Farmer's tax accounting methods and deferred payment contracts*, by Jack H. Taylor.

CRS Report 97-501 E. *Gifts of appreciated stock to private nonoperating foundations*, by Louis Alan Talley.

CRS Report 96-199 E. *The Home office deduction*, by Sylvia Morrison.

CRS Report 97-629 E. *Individual retirement accounts (IRAs): 1997 Revisions and Policy Issues*, by Jane G. Gravelle.

CRS Report 96-20 EPW. *Individual retirement accounts (IRAs): legislative issues in the 105th Congress*, by James R. Storey.

CRS Issue Brief 89148. *Item veto and expanded impoundment proposals*, by Virginia McMurtry.

CRS Report 97-472 E. *Leaking Underground Storage Tank Trust Fund (LUST)*, by Nonna A. Noto and Louis Alan Talley.

CRS Report 97-603 E. *Like-kind exchanges: current tax treatment and proposed reforms*, by Jack Taylor.

CRS Issue Brief 96040. *Major tax issues in the 105th Congress*, by Taxation and Government Finance Section, Economics Division. Updated regularly.

CRS Report 97-796 EPW. *Pension plans: changes made by the Taxpayer Relief Act of 1997*, by James R. Storey.

CRS Report 97-452 E. *President Clinton's FY1998 capital gains tax proposals,* by Gregg A. Esenwein.

CRS Report 97-559 E. *The Revenue cost of capital gains tax cuts*, by Jane G. Gravelle.

CRS Report 97-650 EPW. *Tax benefits for education in the budget reconciliation legislation*, by Bob Lyke.

CRS Report 97-581 E. *Tax subsidies for higher education: an analysis of the administration's proposal*, by Jane Gravelle and Dennis Zimmerman.

CRS Report 96-757 E. *Tax treatment of health insurance for the self-employed,* by Gary L. Guenther.

CRS Report 97-828 E. *Tax-Exempt Bond Provisions of the Taxpayer Relief Act of 1997*, by Dennis Zimmerman.

CRS Report 97-614 E. *Taxes and FY1998 Budget Reconciliation: Highlights of the House, Senate, and Conference Bills*, by David L. Brumbaugh and Gregg Esenwein.

CRS Report 96-607 EPW. *Tuition tax credit and deduction: issues raised by the President's proposals*, by Bob Lyke.

CRS Report 97-540 E. *The Work Opportunity Tax Credit and the 105th Congress*, by Linda Levine.