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Taxes and Fiscal Year 2006 Budget Reconciliation: A Brief Summary

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Summary

On April 28, 2005, Congress approved an FY2006 budget resolution (H.Con.Res. 95) with reconciliation instructions calling for three bills: a bill containing spending cuts ($1.5 billion in FY2006 and $34.7 billion over five years); a bill increasing the public debt limit by $781 billion (to $8,965 billion); and a bill containing tax cuts. The reconciliation instructions for taxes called for tax cuts of $11 billion in FY2006 and $70 billion over five years. As 2005 drew to a close, Congress began consideration of the tax-reduction reconciliation bill. On November 15, both the House Ways and Means Committee and the Senate Finance Committee approved separate tax-cut proposals as H.R. 4297 and S. 2020, respectively. The full Senate approved a slightly modified version of S. 2020 on November 18; the House passed H.R. 4297 on December 8. An important part of both bills is the extension of numerous temporary, tax-reducing provisions that are scheduled to expire at various times over the next several years. Although most of these "extenders" are the same in each package, there are some differences, including extension of the increased alternative minimum tax (AMT) exemption, which is contained in the Senate proposal but not the House bill; and reduced rates for capital gains and dividends, which are in the House measure but not the Senate plan. Aside from the extenders, the Senate bill contains a number of additional items not contained in the House plan, including tax incentives for development in areas affected by recent hurricanes; both tax benefits and reforms related to charitable contributions; and revenue-raising items in the area of tax shelters and elsewhere. In addition, on December 7, the House passed "stand alone" bills extending the increased AMT exemption (H.R. 4096) and providing disaster-related tax benefits (H.R. 4440). The disaster-related bill was approved by the Senate and signed by the President, becoming Public Law 109-135. The remaining differences between the reconciliation bills are expected to be addressed by a conference committee early in 2006.

This report will be updated as legislative developments occur.

The figures in the budget resolution do not place an absolute limit on the tax cuts Congress can pass for FY2006 or subsequent years — for example, the budget resolution itself called for a total of $106 billion in tax cuts over five years — the same amount proposed by President Bush in his FY2006 budget proposal. However, the congressional budget resolution contains only $70 billion in its reconciliation instructions ($11 billion for FY2006). Tax cuts specified in the reconciliation instructions are protected from certain points of order under Senate budget consideration rules; if a point of order is raised, a supermajority is required for passage. Thus, as a practical matter, the $70 billion five-year and $11 billion FY2006 reconciliation figures may place a constraint on the amount of tax cuts that are likely to be considered, and may lead to trade-offs between specific tax cuts or the adoption of revenue-raising offsets. (In addition, Senate rules may further limit the tax cut temporarily to around $60 billion.)

A large number of extended provisions are common to both bills; in most (but not all) cases, the extensions carry through the end of 2006. Some of the more prominent extensions in both bills are:

- the alternative deduction for state and local sales taxes (extended through 2006 in both measures); the research and experimentation tax credit (extended through 2006 in both measures);
- the deduction for higher-education expenses (extended through 2006 in the House proposal and 2009 in the Senate plan); the 15-year depreciation recovery period for leasehold improvements and restaurants (extended through 2006 in both proposals);
- the work opportunity and welfare-to-work tax credits (extended through 2006 in both plans); application of non-refundable tax credits against the AMT (extended through 2006 in both proposals); and
- the increased ($100,000) "expensing" tax benefit for small business investment (extended by both measures through 2009).

Two prominent extensions that differ between the two proposals are the increased alternative minimum tax (AMT) exclusion for individuals and reduced rates for capital gains and dividends. The Senate bill extends the AMT exclusion for one year, but does not extend the capital gains and dividend rate reductions; the House bill extends the rate reductions for two years (through 2010), but does not extend the AMT exemption. (On December 7, however, the House passed H.R. 4096, a stand-alone bill extending the increased AMT exemption.)

Due to the prominence of these two items, some background information is useful. The temporary tax cut for capital gains and dividends was enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27). JGTRRA reduced the tax rate on both capital gains and dividends to 15% (5% for income in the 15% and 10% regular-income brackets, with complete elimination in 2008). However, the reductions are temporary and are scheduled to expire on January 1, 2009. Absent congressional action, the capital gains rate will revert to prior law's 20% rate (10% for income in the lowest brackets). Dividends will be taxed under the tax rates applicable to regular income, which range from 10% to 35%, but which are also scheduled to revert to a 15% to 39.6% range in 2011. According to JCT estimates, a two-year extension of the reduced rates for capital gains and dividends would reduce revenue by an estimated $20.6 billion over five years and $50.7 billion over 10 years.[1]

The context of the AMT exemption's extension is this: individuals generally pay either their AMT or regular tax, whichever is higher; a taxpayer's tentative AMT is partly dependent on a flat exemption amount specified by law. The value of the exemption is subject to erosion due to inflation and the growth of real income. Partly for this reason, an increasing number of taxpayers are faced with the possibility of paying the AMT rather than the regular tax. Beginning in 2001, Congress enacted a series of temporary increases in the exemption. The most recent increase was provided by the Working Families Tax Relief Act of 2004 (P.L. 108-121). Under its terms the exemption is $58,000 for couples and $40,250 for individuals. However, the increase expires at the end of 2005, and — absent congressional action — in 2006 the exemption will revert to prior law's level of $45,000 and $33,750 for couples and individuals respectively. According to estimates by the Joint Committee on Taxation (JCT), extension of the provision would result in a revenue loss of $30.5 billion over five years.[2]

Aside from the extenders, the Senate bill contains a number of additional items not in the House bill. These include a number of tax cuts for areas affected by the recent hurricanes, a set of provisions applying to charitable contributions, and a number of revenue-raising provisions. The disaster-related provisions are generally more in the nature of development incentives for stricken areas than were the provisions of the Katrina Emergency Tax Relief Act (P.L. 109-73) that Congress enacted in September. The earlier measure generally focused more on providing direct tax relief to individuals affected by the hurricanes, providing, for example, more generous rules for deducting casualty losses and a set of tax benefits for charitable giving. The Senate bill would generally extend KETRA's scope to include victims of Hurricanes Rita and Wilma. In addition, it contains a package of tax benefits for development in the affected areas, and includes provisions such as bonus depreciation for investment in the Gulf area and increased low-income housing tax credits. On December 7, the House passed a stand-alone bill (H.R. 4440) containing a set of disaster-related tax benefits similar to those in S. 2020. The disaster-related bill was approved by the Senate and signed by the President, becoming Public Law 109-135.

The charity-related items in the Senate bill include both tax benefits and revenue-raising measures. The tax cuts include a proposal that would allow tax-free withdrawals from IRAs if used for charitable purposes and a provision to allow non-itemizers to deduct charitable contributions in certain circumstances. (The proposal, however, would also institute a minimum "floor" amount below which a deduction is not permitted for itemizers.) Revenue-raising items in the charitable area include provisions intended to curtail the involvement of tax-exempt organizations in tax shelters and the doubling of certain fines and penalties applicable to charitable organizations.

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[1] A one-year extension that was dropped by the Finance Committee would reduce revenue by an estimated $11.7 billion over five years and $26.2 billion over 10 years.

[2] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Tax Provisions Contained in S. 2020, the "Tax Relief Act of 2005," As Passed by the Senate on November 18, 2005*, JCX-82-05, Nov. 29, 2005, 8 pp. Available on the Joint Committee's website at [http://www.house.gov/jct/x-82-05r.pdf].

In terms of revenue impact, the largest of the revenue-raising items is codification of the "economic substance" doctrine that is aimed at suppressing corporate tax shelters. Other revenue-raisers are additional measures designed to suppress the movement of U.S.-chartered parent corporations to low-tax countries (corporate "inversions" or "expatriation") and a requirement that large oil companies that use the Last In First Out (LIFO) method of inventory accounting revalue their inventories.

According to estimates by the Joint Committee on Taxation (JCT), the version of S. 2020 approved by the full Senate would reduce revenue by $57.8 billion over five years, by $37.4 billion over 10 years, and $11.0 billion in FY2006.[3] (The bill approved by the full Senate differed slightly from the Finance Committee proposal.) The House bill is estimated to reduce revenue by $56.1 billion over five years, $80.5 billion over 10 years, and by $5.8 billion in FY2006.[4]

There is little doubt that debate over reconciliation legislation will, in part, focus on its specific provisions, their fairness, and their likely economic impact. Supporters of the tax cuts in general, however, have in some cases cited philosophical reasons: a belief in low tax burdens. In addition, supporters link the economy's recovery from the 2001 recession to the tax cuts enacted in EGTRRA, JGTRRA, and elsewhere, arguing that the stimulus from the tax cuts helped make the slump shorter and less severe than it otherwise would have been. It is argued that continuation of those cuts — many of which will expire without congressional action — is important to sustain economic growth.[5] Opponents of the tax cuts have generally questioned the prudence of enacting tax cuts in a time of budget deficits, and also tend to be skeptical of the tax cuts' beneficial economic effects.[6]

[3] Ibid., p. 6.

[4] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4297, the "Tax Relief Extension Reconciliation Act of 2005," as Reported by the Committee on Ways and Means*, JCX-81-05, Nov. 18, 2005, 3 pp. Available on the Joint Committee's website at [http://www.house.gov/jct/x-81-05.pdf].

[5] See, for example, the statement of Sen. Gregg, Chairman of the Senate Budget Committee, remarks in the Senate, *Congressional Record*, daily edition, vol. 151, Mar. 14, 2005, pp. S2588-S2591, and the introductory language in the report of the House budget committee, U.S. Congress, House, Committee on the Budget, *Concurrent Resolution on the Budget — Fiscal Year 2006*, report to accompany H.Con.Res. 95, 109th Cong., 1st sess., H.Rept. 109-17 (Washington: GPO, 2005), p. 7.

[6] See Sen. Kent Conrad, remarks in the Senate, *Congressional Record*, daily edition, vol. 151, Mar. 14, 2005, pp. S2591-S2596.