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# Major Tax Issues in the 109th Congress

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## Summary

During the first part of 2006, congressional deliberations on tax policy returned to their focus at the close of 2005: budget reconciliation. The fiscal year (FY) 2006 budget resolution (H.Con.Res. 95), approved in April 2005, called for net tax cuts totaling $17.8 billion for FY2006 and $105.7 billion over five years. $11.0 billion of the FY2006 tax cuts and $70.0 billion in cuts over five years were included in reconciliation instructions.

In late 2005, the Senate and House approved separate tax reconciliation bills. Prominent in both bills was the extension of a number of temporary tax-reducing provisions scheduled to expire over the next several years. The bills differed, however, in the precise list of provisions that would be extended and in the length of several extensions. Prominent extensions in both plans included the research and experimentation tax credit and the "expensing" benefit for small business investment. Items that differed were extension of the increased minimum tax exemption (present in the Senate bill, but not the House measure) and reduced rates for dividends and capital gains (contained in the House bill, but not the Senate plan). Also, the Senate plan (but not the House bill) contained tax provisions related to charitable contributions and a number of revenue-raising items. On May 9, 2006, a conference committee approved a reconciliation tax bill (H.R. 4297; enacted as P.L. 109-222) that extends both AMT relief and dividend and capital gains tax cuts, as well as an increased expensing benefit. The bulk of the remaining extensions, however, were not in the agreement, nor were most revenue-raising measures of the Senate bill.

Another tax issue that may receive congressional attention in 2006 is extension of temporary tax cuts in 2001 with the Economic Growth and Tax Relief Recovery Act (EGTRRA; P.L. 107-16). The act contained several broad tax cuts, including tax rate reductions, tax cuts for married couples, repeal of the estate tax, and an increased child credit. However, because of a Senate procedural rule, EGTRRA included a "sunset" provision that repeals its tax cuts at the end of 2010. Congress may also consider fundamental tax reform in 2006. In November 2005, a Presidential advisory panel on tax reform issued a report that recommended two alternative reform plans. In Congress, a number of tax reform plans have been introduced as legislation. The alternative minimum tax (AMT) may likewise receive continued congressional attention. Absent congressional action, an increasing number of persons are likely to be subject to the AMT — a result of certain structural features of the AMT and the recent cuts in the regular income tax.

On February 6, the Administration released the details of its FY2007 budget proposal. The plan proposes to cut taxes by $29 billion in FY2007 and $280 billion over FY2007-FY2011. The centerpiece of the tax cuts is extension of the tax reductions that are scheduled to expire under current law.

This report will be updated as tax-related legislative activity occurs.

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# Major Tax Issues in the 109th Congress

Congress debated a number of tax topics in 2005, although major tax legislation was not enacted. One topic was fundamental tax reform — the Administration has indicated that consideration of a basic restructuring of the tax system is one of its chief domestic policy priorities for its second term. Other topics receiving congressional attention were revision of the alternative minimum tax and extension of tax cuts that are scheduled to expire. Each of these topics is likely to continue to receive congressional attention in 2006.

As 2005 drew to a close, congressional attention turned to budget reconciliation. In April, 2005, Congress approved an FY2006 budget (H.Con.Res. 95) calling for $105.7 billion of tax cuts over five years and $17.8 billion of cuts in FY2006. $70 billion of the tax cuts were included in reconciliation instructions over five years, and $11 billion are included for FY2006. Under Senate rules, tax cuts not included in reconciliation may be subject to a point of order and require a supermajority (60 votes) for passage.

On November 15, the House Ways and Means Committee and the Senate Finance Committee passed their own versions of tax reconciliation legislation as H.R. 4297 and S. 2020, respectively. The full Senate approved S. 2020 on November 18 and the House passed H.R. 4297 on December 8. On February 2, 2006, the Senate approved H.R. 4297 after amending it by replacing the contents of the House-passed bill with those of S. 2020. An important part of both the House and Senate bills was the extension of various expiring tax provisions, although the plans differed in the particulars of their respective extensions. A prominent difference between the bills was the presence in the Senate bill (but not the House bill) of an extension for an increased minimum tax exemption and the presence in the House bill (but not the Senate's) of an extension of reduced rates for dividends and capital gains. Also, the Senate proposal contained disaster-related tax cuts, measures aimed at charitable contributions, and a set of revenue-raising items not contained in the House bill. On December 7, however, the House passed "stand alone" bills extending minimum tax relief (H.R. 4096) and providing disaster-related tax benefits (H.R. 4440). The Senate did not approve the stand-alone AMT bill, but it approved the disaster-related bill, which was signed by the President and became P.L. 109-135. On May 9, a conference committee approved a compromise version of H.R. 4297 (see the section below on taxes and budget reconciliation for details), and the bill was enacted as P.L. 109-222.

On February 6, the Administration released the details of its FY2007 budget proposal. The plan proposes to cut taxes by $29 billion in FY2007 and $280 billion over FY2007-FY2011. The centerpiece of the tax cuts is extension of the tax reductions that are scheduled to expire under current law.

Before looking at specific tax issues likely to be addressed in 2006 and at recent developments, however, it is useful to briefly review the economic context in which issues may be considered.

# The Economic Context

Tax policy is frequently considered by policymakers as a tool for boosting economic performance in various ways, and the likely economic effects of tax policy are often hotly debated. For example, if the economy is sluggish and unemployment is high, tax cuts are sometimes recommended by some as a fiscal stimulus to boost demand. Or, in the longer term, tax cuts for saving and investment are championed by some as a means of boosting long-term economic growth. At the same time, taxes can also affect long-run growth through the federal budget — along with spending, tax revenues determine the size of the budget surplus or deficit. And the size and nature of the budget balance can affect long-run growth by determining the extent to which government borrowing needs compete for capital with private investment, thus damping long-run growth.

Taxes also have a distributional effect. That is, the rate and manner in which taxes apply to different activities, groups, and income levels can alter the distribution of income within the economy. For example, the taxes can affect the distribution of income across income levels (can affect "vertical equity") by applying at different rates to different income levels. And taxes can affect "horizontal equity" by applying differently to different types of income.

With these broad economic effects in mind, a discussion of three aspects of the economy follows. First is a look at the current state of the economy, both in terms of long-run growth and the short-run state of the business cycle. Next is a review of the current, recent, and expected future state of the federal budget. Third is a brief review of the level and distribution of the tax burden.

## The State of the Economy

In 2005, the economy continued its expansion and recovery from the recession that reached its trough in November 2001; the economy has now registered positive real economic growth for 17 consecutive quarters. Real growth was relatively sluggish during the first quarters of the recovery, but began to pick up momentum in mid-2003. In 2004, real gross domestic product (GDP) grew at a 4.4% rate, compared to 3.0% in 2003. In the first three quarters of 2005, the economy grew at rates of 3.8%, 3.3%, and 4.1%, before slipping to 1.7% in the fourth quarter. Growth picked up again in the first quarter of 2006, rising to 5.3%. The favorable economic performance is qualified, however, by relatively slow growth in employment (leading some to characterize the current situation as a "jobless recovery").

Although the current economic context of tax policy is thus one of growth, one principal focus of the tax policy debate in recent years has been the efficacy of tax cuts as an economic stimulus. The tax cuts of 2001, 2002, and 2003 were enacted, in part, as a means of stimulating a still-sluggish economy, and although the recession has ended and economic growth has picked up momentum, the debate over the merits of tax cuts as economic stimulus continues to resonate. For example, one subject of current debate is the extent to which tax cuts are responsible for the economy's rebound and the extent to which factors such as monetary policy are responsible.[1] It is thus informative to review the main outlines of economic performance over the past few years.

The economic boom of the 1990s lasted nine consecutive years, but by late 2000, the economy began to show signs of weakness. President-elect Bush had called for a tax cut during the election campaign for philosophical reasons and to spur long-term growth, but as 2000 came to an end, he added that a tax cut would also be advisable as a means of providing a near-term fiscal stimulus to the sluggish economy. The tax cut he proposed in January 2001 ultimately became the basis for the large reduction enacted as EGTRRA in June 2001.

As 2001 progressed, there were increasing signs of economic weakness, and in November, the National Bureau of Economic Research (NBER; the organization that tracks business cycles) determined that a recession had begun in March of that year. Economic data now show that the economy contracted during the first and third quarters of 2001 before registering positive growth again in the fourth quarter of that year. The recession ended in November 2001, having lasted eight months. The recession was of about average severity and duration for economic recessions of the post-World War II era.[2]

Following the recession, the economy registered positive growth in all four quarters of 2002 and 2003, but still exhibited signs of sluggishness. Business investment spending was weak and employment continued to decline. Further, the pattern of growth was uneven, leading observers to characterize the economy's performance since the end of the recession as "choppy" and "sub-par." Several factors were thought to be placing a drag on the economy: a long adjustment in capital spending; the "fallout" from revelations of corporate malfeasance; declines in the stock market; and increased "geopolitical risks," including the possibility of war in Iraq. Investment spending picked up in 2004 and 2005, led by the residential sector.

Economic growth was strong from the second half of 2003 onward. The performance is qualified, however, by the labor market. Payroll employment has increased, but at slower rates than in the 1990s. The unemployment rate has gradually declined since 2003, and is now lower than it was during all but the last three years of the 1990s expansion.

This section was co-authored by Marc Labonte, Specialist in Macroeconomics, Government and Finance Division. For further reading, see CRS Report RL30329, *Current Economic Conditions and Selected Forecasts*, by Gail Makinen.

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[1] For an analysis, see CRS Report RL32502, *What Effects Have the Recent Tax Cuts Had on the Economy?*, by Marc Labonte.

[2] CRS Report RL31237, *The 2001 Economic Recession: How Long, How Deep, and How Different from the Past?*, by Marc Labonte and Gail Makinen.

## The Federal Budget

In its January 2006 report, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*, the Congressional Budget Office (CBO) reported that the federal budget registered a deficit in FY2005 amounting to 2.6% of GDP after having risen to 3.6% of GDP in FY2004.[3] The deficit in FY2005 marked the fourth year in a row the budget registered a deficit, but for the first time since the deficits reemerged in FY2002, the size of the deficit declined as a percentage of GDP. CBO's report also projects a continued gradual decline in the deficit as percentage of GDP, shrinking to a position of near-balance (a deficit of 0.7% of GDP) by 2011. As described below, however, this projection assumes that current policies remain in place, and if that assumption is dropped, the outlook changes — an important consideration given congressional interest in extending or making permanent the 2001 and 2003 tax cuts, many of which are scheduled to expire at the end of calendar year 2010.

A broader historical perspective shows several reversals in the federal budget situation in recent years. The budget was in deficit throughout the 1970s, 1980s, and most of the 1990s before registering a surplus in FY1998, a result of both the booming economy and legislation designed to enforce budget discipline. The budget surplus grew for the next two years, reaching a peak of 2.4% of GDP in FY2000 before declining in FY2001 and moving into deficit in FY2002 and FY2003. The difference between the surplus in FY2000 and the deficit in FY2005 amounted to 6.0% of GDP. The budget data indicate that the change was a result of both a growth in outlays and a decline in revenues. The decline in revenues was more pronounced, however; revenues declined from 20.9% of GDP in FY2000 to 16.3% in FY2004, a drop of 4.6 percentage points. Outlays increased by only 1.7 percentage points over the same period. The decline in revenues had two sources: the recession of 2001 and subsequent sluggish economic growth, and enacted tax cuts.

The decline in the relative size of the deficit in FY2005 resulted from an increase in revenues; receipts increased by 1.2% of GDP (to 17.5%) while outlays grew by 0.2% of GDP (to 20.1%). The increase in total receipts in FY2005 reflected increases in individual income tax receipts, corporate tax receipts, and social security receipts.

The outlook, however, may change. As described elsewhere in this report, the tax cuts enacted in 2001 by EGTRRA expire at the end of calendar year 2010; parts of JGTRRA's acceleration of EGTRRA (as extended by legislation in 2004) expire at various times before 2010. Extending the tax cuts would have a substantial impact on the budget, particularly after 2010. In addition, the application of the alternative minimum tax (AMT) to an increasing number of taxpayers may exert pressure to increase the AMT's exemption amount. CBO's January *Budget and Economic Outlook* estimated that extending all tax provisions scheduled to expire between 2006 and 2016 (except those related to the AMT) would reduce federal revenue by $2.0

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[3] U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (Washington: GPO, 2006), p. 141.

trillion over fiscal years 2007-2016, an amount equal to 5.8% of CBO's baseline projection of revenues for the period.[4]

The longer-term budget situation is a concern to many policymakers, chiefly because of the combination of rising health care costs and demographic pressures posed by an aging population that will begin with the retirement of the "baby boom" generation. Under current law, spending on Social Security, Medicare, and Medicaid is expected to increase substantially as a share of the economy. CBO's December 2005 analysis of the long-term budget outlook projected several different scenarios for growth of the three programs. Under its "intermediate" projection, CBO estimates that spending on the programs will grow the current level of 8.2% of GDP in FY2005 to 15.2% in FY2030 and 19.0% by FY2050.[5] According to CBO, either increases in taxes or cuts in spending will be necessary in the future if fiscal stability is to be maintained.[6]

For additional information, see CRS Report RL32812, *The Budget for Fiscal Year 2006*, by Philip D. Winters and CRS Report RS21786, *The Federal Budget Deficit: A Discussion of Recent Trends*, by Gregg Esenwein, Marc Labonte, and Philip D. Winters.

## The Federal Tax Burden

The broadest gauge of the federal tax burden is the level of federal receipts as a percentage of output (gross domestic product, or GDP). By this measure the federal tax burden has fluctuated considerably over the past five years. In FY2000, federal receipts reached a post-World War II peak as a percentage of output, at 20.9%. By FY2004, however, receipts had fallen to 16.3% of GDP — their lowest level since 1959 — before rising again to 17.5% in FY2005. In part, the fluctuations were a result of the business cycle; the long economic boom of the 1990s helped push receipts to their record level in FY2000, while the ensuing recession and sluggish recovery helped reduce the level of revenues in subsequent years. However, policy changes, too, were responsible: significant tax cuts in 2001, 2002, and 2003 each contributed to the decline in taxes.

Another way to look at the tax burden is to compare it across income classes. In combination, the various components of the federal tax system have a progressive impact on income distribution — that is, upper-income individuals tend to pay a higher portion of their income in tax than do lower-income persons. In isolation, however, the different components of the system have different effects: the individual income tax is progressive, while payroll taxes are progressive in the lower and middle parts of the income spectrum but become regressive as incomes increase. The corporate income tax and estate tax are both progressive, although they impose only a small burden; excise taxes are regressive.

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[4] Ibid., p. 16.

[5] U.S. Congressional Budget Office, *The Long-Term Budget Outlook* (Washington: GPO, 2005), p. 10.

[6] Ibid., p. ix.

CBO has published distributional analyses for all federal taxes for each year since 1979; the studies use a consistent methodology, so the results can be compared to get an idea of the direction of federal tax policy's distributional impact over the period. According to the studies, the overall effective federal tax rate declined from 22.2% of income in 1979 to 19.8% in 2003, but is estimated to have risen to 21.4% in 2005. Without more detailed analysis, it is not clear whether the system has become more or less progressive over the entire period; while rates in all quintiles have fallen the pattern is mixed.[7] Since 2000, the system has apparently become slightly less progressive. While the effective tax rate for each quintile of households in the income scale has declined, the decline has tended to be larger for successively higher quintiles.[8]

For further information, see CRS Report RS20087, *The Level of Taxes in the United States, 1940-2003,* by David L. Brumbaugh and Don C. Richards; and CRS Report RL32693, *Distribution of the Tax Burden Across Individuals: An Overview*, by Jane G. Gravelle and Maxim Shvedov.

# Possible Tax Issues in 2006

## Taxes and Budget Reconciliation

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 entered its closing months, Congress began consideration of the tax-reduction reconciliation legislation. On November 8, Chairman Grassley of the Senate Finance Committee released the details of a "chairman's mark," containing the proposed contents of a tax reconciliation bill. On November 10, Chairman Thomas of the House Ways and Means Committee introduced his own chairman's mark. On November 15, both committees approved modified versions of the respective chairman's marks (S. 2020 in the Finance Committee and H.R. 4297 in the Ways and Means Committee). On November 18, the full Senate approved S. 2020, with slight modifications, and the House approved H.R. 4297 on December 8. On February 2, 2006, the Senate approved H.R. 4297 after amending it by replacing the contents of the House-passed bill with those of S. 2020.

[7] U.S. Congressional Budget Office, Effective Federal Tax Rates Under Current Law, 2001 to 2014 (Washington: GPO, 2004), p. 10; and Historical Effective Federal Tax Rates, 1979 to 2003 (Washington: GPO, 2005). Both reports are available on the CBO website, at [http://www.cbo.gov/], visited Feb. 10, 2006. The percentage-point declines across quintiles, from lowest to highest, are 2.5, 2.3, 3.0, 1.6, and 1.2.

[8] For the lowest to highest quintiles, respectively, the percentage-point declines in effect tax rates between 2000 and 2005 were: 0.9, 1.0, 1.1, 0.9, and 1.7.

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, with only $70 billion contained in budget reconciliation instructions. However, 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 pose 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.

An important element of both the House and Senate bills was the extension of a number of previously enacted temporary tax cuts that are scheduled to expire at various times over the next several years. (Note that these measures are generally distinct from the relatively broad cuts in tax rates and other areas that were enacted in 2001 with the Economic Growth Tax Relief and Reconciliation Act, but that are scheduled to expire at the end of 2010.) According to estimates by the Joint Committee on Taxation (JCT), the Senate bill would reduce revenue by $69.4 billion over five years, by $49.5 billion over 10 years, and by $983 million in FY2006.[9] The House bill was estimated to reduce revenue by $55.6 billion over five years, $80.1 billion over 10 years, and by $4.9 billion in FY2006.[10]

A large number of extended provisions were common to both bills; in most (but not all) cases, the extensions carried through the end of 2006. Some of the more prominent extensions in both bills were the alternative deduction for state and local sales taxes, the research and experimentation tax credit, the deduction for higher-education expenses, the 15-year depreciation recovery period for leasehold improvements and restaurants, and the work opportunity and welfare-to-work tax credits. Both bills also extended the increased "expensing" tax benefit for small business investment through 2009.

Two prominent extensions that differed between the two proposals were the increased alternative minimum tax (AMT) exclusion for individuals and reduced rates for capital gains and dividends. The Senate plan extended the AMT exclusion for one year, but did not extend the capital gains and dividend rate-reductions; the House bill extended the dividend and capital gains reductions for two years (through 2010), but did not extend the AMT exclusion. The House bill did, however, extend the applicability of nonrefundable personal tax credits against the AMT for one year, as did the Senate bill (albeit for two years). In addition, on December 7, the House passed a one-year extension of the increased AMT exemption as a "stand alone" bill (H.R. 4096).

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[9] U.S. Congress, Joint Committee on Taxation, *Comparison of the Estimated Revenue Effects of the Tax Provisions Contained in H.R. 4297, the "Tax Relief Extension Reconciliation Act of 2005," As Passed by the House, and H.R. 4297, the "Tax Relief Act of 2005," As Amended by the Senate*, JCX-10-06, Feb. 9, 2006, 7 pp. Available on the Joint Committee's website at [http://www.house.gov/jct/x-10-06.pdf].

[10] Ibid., p. 7.

Due to the prominence of the AMT and dividend/capital gains issues, 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 $50.8 billion over 10 years.[11]

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), a one-year extension of both the increased exemption and the AMT-applicability of personal tax credits would result in a revenue loss of $33.9 billion over five years.[12]

In addition to the differences between the "extenders," the Senate proposal contained several sets of items not contained in the House bill. These included a number of tax cuts for areas affected by the recent hurricanes and a set of provisions applying to charitable contributions. The disaster-related provisions were 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 was enacted in September. The early measure generally focused more on providing direct tax relief to individuals affected by the hurricanes. While disaster-related provisions were not contained in the House reconciliation bill (H.R. 4297), on December 7, the House passed H.R. 4440, containing disaster-related tax benefits. The Senate passed the bill on December 16, and the President signed the measure (P.L. 109-135).

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[11] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Conference Agreement for the "Tax Increase Prevention and Reconciliation Act of 2005,"* JCX-18 — 06, May 9, 2006, p. 2. Available on the committee's website, at [http://www.house.gov/jct/x-18-06.pdf].

[12] Ibid., p. 2.

The Senate bill included several incentives to encourage charitable giving: a non-itemizer deduction; an allowance for tax-free distributions from IRAs for charitable purposes; an enhanced deduction for charitable contributions of food and book inventory; a basis adjustment to the stock of S corporations[13] that contribute property for charitable purposes; and a change in the tax treatment of certain payments to controlling exempt organizations.

Although these proposals would reduce revenue, the Senate bill also included charity-related reforms that would raise revenue. These include provisions intended to limit the involvement by exempt organizations in tax-shelter transactions; doubling certain fines and penalties applicable to charitable organizations; and implementation of certain other changes.[14]

The Senate proposal contained a number of additional revenue-raising measures, which are also not present in the House bill. The largest of these is codification of the "economic substance" doctrine that is aimed at suppressing corporate tax shelters. Another prominent revenue-raiser was a proposal to require large integrated oil companies who use the Last In First Out (LIFO) method of inventory accounting to revalue their inventories.

**The Conference Agreement.** On May 9, a conference committee approved a budget reconciliation tax bill (H.R. 4297, the Tax Increase Prevention and Reconciliation Act of 2005. The President signed the measure on May 17; it became P.L. 109-222.) The bill extends both the dividend and capital gains reduction (for two years) and AMT relief (for one year), and would also extend the increased business expensing allowance. The conference agreement, however, does not include most other extensions contained in the House and Senate bills. (According to press reports, the extensions not contained in H.R. 4297 may be addressed by subsequent legislation not included in the budget reconciliation process.[15]) In addition, the conference agreement does not contain the bulk of the revenue-raising items contained in the Senate bill. It does not include, for example, either modifications to the economic substance doctrine or accounting changes for oil companies. Joint Committee on Taxation estimates indicate the conference agreement would reduce revenue by a net amount of $70 billion over five years and by $10.8 billion in FY2006.[16]

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[13] "S corporations" are corporations that are relatively closely held and, having met requirements set forth in the tax code, are not subject to the corporate income tax. S corporation shareholders are taxed on their share of S-corporation income, however, whether it is paid as dividends or not.

[14] Pamela J. Jackson contributed the sections on charitable giving.

[15] Kurt Ritterpusch, "Conferees Reach Reconciliation Accord, Strip Some FSC Benefits to Offset Cost," BNA *Daily Tax Report*, May 10, 2006, p. GG-1.

[16] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Conference Agreement for the "Tax Increase Prevention and Reconciliation Act of 2005,"* JCX-18 — 06, May 9, 2006, p. 3. Available on the committee's website, at [http://www.house.gov/jct/x-18-06.pdf].

The conference agreement's one-year extension of AMT provisions applies to 2006, and includes both the applicability of personal tax credits against the AMT that was contained in both the House and Senate bills (though for different periods) and the increased exemption amount. The increased exemptions would be higher than those applicable to 2005, reflecting indexation for inflation. The exemption amount would be $62,550 for joint returns and $42,500 for single returns.

The extended dividend/capital gains tax cut would apply to 2008 and 2009. The increased expensing provision would be extended for two years, for 2008 and 2009.

For additional information on the budget, see CRS Report RL32812, *The Budget for Fiscal Year 2006*, by Philip Winters. For more information on expiring tax provisions, see the section below.

## Tax Policy and Hurricane Katrina

On September 21, the House and Senate agreed on a package of tax cuts designed to assist victims of Hurricane Katrina. The Joint Tax Committee estimated that the enacted version of the bill — the Katrina Emergency Tax Relief Act (KETRA; P.L. 109-73) — would reduce revenue by $6.1 billion over FY2006 — FY2010, with the bulk of the revenue reduction occurring in FY2006 and FY2007. In general, the act's provisions were aimed at providing direct relief to Katrina's victims and contained provisions aimed at cash flow, employment, charitable giving, and administration actions by the Internal Revenue Service.

The act's principal provisions are:

- relaxed rules for Individual Retirement Account (IRA) and retirement plan withdrawals related to Katrina;
- employment-related tax benefits, including extension of the Work Opportunity Tax Credit to the Katrina-affected area;
- a set of tax benefits for charitable giving, including temporary suspension of limits on qualified contributions;
- more generous rules for deducting casualty losses, including suspension of the 10% and $100 loss thresholds; and
- an extension of the replacement period within which capital gain is not recognized in involuntary conversions (e.g., instances where a destroyed asset is replaced with another).

Subsequent disaster-related tax proposals have focused more on development incentives. As described above, the budget reconciliation measure approved as S. 2020, by the Senate November 18, contained a set of additional tax benefits in response to the recent hurricanes. Prominent among the provisions were "bonus" depreciation deductions for investment in Gulf areas affected by Hurricanes Katrina, Rita, and Wilma; an increase in the "expensing" benefit for equipment investment in the affected areas; an expansion of tax-exempt private activity bonds that governments in the affected area can issue; and an increase in the area's low-income housing tax-credit allocation. Along with its development incentives, S. 2020 also generally proposed to extend KETRA's relief provisions to victims of Hurricanes Rita and Wilma.

On December 7, the House passed H.R. 4440, containing a set of disaster-related benefits similar (though not identical) to those in the Senate reconciliation package. As noted above, the bill was passed by the Senate on December 16 and signed by the President (P.L. 109-135).

For a more comprehensive description of KETRA, see CRS Report RS22269, *Katrina Emergency Tax Relief Act of 2005*, by Erika Lunder. For an economic analysis of the bill's provisions, see CRS Report RL33088, *Tax Policy Options After Hurricane Katrina*, by Jane G. Gravelle.

## Scheduled Expiration of Enacted Tax Cuts

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) provided a substantial tax cut that it scheduled to be phased in over the 10 years following its enactment. However, to comply with a Senate procedural rule (the "Byrd rule"), the act contained language "sunsetting" its provisions after calendar year 2010. Thus, all of EGTRRA's tax cuts expire at the end of 2010.

The most prominent provisions EGTRRA scheduled for phase-in were:

- reduction in statutory individual income tax rates;
- creation of a new 10% tax bracket;
- an increase in the per-child tax credit;
- tax cuts for married couples designed to alleviate the "marriage tax penalty"; repeal of the estate tax; and
- tax cuts under the individual alternative minimum tax.

The Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) provided for the "acceleration" of most of EGTRRA's scheduled tax cuts — that is, it moved up the effective dates of most the tax cuts EGTRRA had scheduled to phase-in gradually, generally making them effective immediately. (The phased-in repeal of the estate tax was not accelerated by JGTRRA.) Many of JGTRRA's accelerations, however, were themselves temporary and were scheduled to expire at the end of 2004.

In 2004, Congress thus faced two "expiration" issues related to EGTRRA and JGTRRA. One was a question for the longer term: the scheduled expiration of EGTRRA's tax cuts at the end of 2010. The second was the expiration of JGTRRA's accelerations at the end of 2004. In September, Congress addressed the second of these with enactment of the Working Families Tax Relief Act (WFTRA; P.L. 108-311). WFTRA generally extended JGTRRA's accelerations of EGTRRA's tax cuts through 2010 — that is, up to the point at which EGTRRA's cuts are scheduled to expire.

The issue of EGTRRA's scheduled expiration at the end of 2010 thus remains, and policymakers in both the Administration and Congress have indicated their desire to consider the issue during the Bush Administration's second term. And in April, 2005, the House passed legislation (H.R. 8) that would make EGTRRA's temporary estate tax permanent.

Along with its accelerations of EGTRRA's tax cuts, JGTRRA contained an increase in the alternative minimum tax exemption-amount that was effective only for 2004. WFTRA extended the increase, but only through 2005, thus posing an additional time sensitive issue, as discussed more fully below in the section on the minimum tax. Further, the tax code contains numerous other temporary tax-reducing provisions beyond those contained in EGTRRA and JGTRRA. These provisions — sometimes termed "extenders" — have typically been temporary from their inception, have been scheduled to expire at various times in the past, but have been extended by Congress. While WFTRA included an extension of many of these provisions with its extension of JGTRRA's accelerations, the extensions were generally only through 2005, and the 109$^{th}$ Congress may thus consider their extension.

Debate over extension of the EGTRRA tax cuts has centered on three broad issues: its likely impact on the federal budget deficit; its possible effect on long-term economic growth; and its results for the fairness of the tax system. In general, opponents of an extension have argued that it would exacerbate a budget situation already made difficult by the looming retirement of the baby-boom generation and resulting stresses on the social security system. Those supporting extension maintain that the tax cuts — through their positive effects on work effort and saving — will stimulate long-term growth, a development that will ease the adverse effects of the tax cuts on the budget. (Opponents question whether these effects will be large enough to offset the extensions' budget effects.) With respect to fairness, opponents of extending the measures argue that the tax cuts reduce the progressivity of the tax system by providing larger effective tax-rate reductions for upper-income individuals than for persons in lower income brackets. Proponents of the tax-cut extensions emphasize that they would provide tax cuts across all income classes.

For additional information on the expiring provisions of EGTRRA and JGTRRA, see CRS Report RS21863, *Recent House Legislation Extending Selected Provisions of the 2001 and 2003 Tax Cuts*, by Gregg Esenwein. For information on the extenders, see CRS Report RL32439, *Temporary Tax Provisions ('Extenders') Scheduled to Expire in 2004*; and CRS Report RS22117, *List of Temporary Tax Provisions: 'Extenders' Expiring in 2005*, by Pamela J. Jackson. For a comprehensive list of temporary tax code provisions and their scheduled expiration date, see U.S. Congress, Joint Committee on Taxation, *List of Expiring Federal Tax Provisions, 2004-2014* (Washington: December 23, 2004), 16 pp. (available on the Joint Committee's website at [http://www.house.gov/jct/x-71-04.pdf], visited December 28, 2004).

## The Alternative Minimum Tax for Individuals

While EGTRRA's expiration presents a timing issue focused on a specific date, the individual AMT is an issue for which time is a critical element but in a less specific way: absent legislative action, as each year passes more and more individuals will be subject to the AMT rather than the regular tax. According to one recent study, in 2001 2.4 million individual income tax returns (1.8% of the total) contained an AMT liability; in 2004 an estimated 3.5 million returns (2.6%) had an AMT liability. In 2010, an estimated 37.1 million returns (25.6%) will owe the AMT.[17] The portion will decline for a number of years thereafter if EGTRRA's expiration occurs as scheduled, but then will resume growth.

The reason for the increase in the applicability of the AMT is its basic mechanics. The AMT functions like a parallel income tax, with lower rates than the regular tax but with a broader base — that is, with fewer deductions, exemptions, credits, and special tax preferences than are allowable under the regular tax. Each year, a taxpayer pays either his or her regular tax or the tentative AMT, whichever is higher. Taxpayers are permitted a flat exemption amount in calculating their AMT. However, the exemption is fixed at a flat dollar amount that is not indexed for inflation. And while the AMT only has two rate brackets (26% and 28%), the bracket dividing point is likewise not indexed. In contrast, the structural features of the regular income tax — personal exemptions, the standard deduction, and rate-bracket thresholds — are indexed. Thus, as time passes and incomes grow in both real and nominal terms, the AMT exceeds the regular tax for more taxpayers. The phenomenon was magnified by the rate reductions and tax cuts for married couples provided by EGTRRA and JGTRRA as well as other tax cuts enacted in the past. As described above, Congress addressed the AMT on a temporary basis in 2001 and 2003 under EGTRRA and JGTRRA by increasing the exemption amount, thus reducing the number of taxpayers who would otherwise pay the AMT. Most recently, WFTRA extended through 2005 an exemption amount of $58,000 for married couples and $40,250 for single filers. However, WFTRA's provision expires at the end of 2005 and without additional legislative action the exemption amount will revert to its pre-EGTRRA levels of $45,000 and $33,750 for couples and singles, respectively. As described above, budget reconciliation legislation under consideration in the spring of 2006 may extend the increased exemption.

The original purpose of the AMT was to ensure that no individual with substantial income measured in economic terms could use tax benefits and omissions from the tax base to reduce his or her tax liability below a certain point. There are a number of reasons why policymakers may be concerned with the prospect of its increased applicability. First, taxpayers who become subject to the AMT face a higher tax liability than they otherwise would; some taxpayers moving into AMT status may thus view the applicability of the AMT as a tax increase. Second, taxpayers in AMT status are not able to fully participate in tax cuts enacted under the regular tax. For example, application of the AMT prevented those taxpayers subject to the AMT from fully realizing the tax cuts enacted under EGTRRA and JGTRRA. Third, the AMT introduces complexity to the tax system, and the amount of time spent in tax preparation increases for taxpayers in or near AMT status.

On a more conceptual level, the AMT can be viewed as balancing conflicting goals of the income tax. On the one hand, various deductions, exemptions, credits, and other benefits under the regular income tax are thought to be useful in promoting various activities thought to be socially desirable or conducive to economic growth. On the other hand, it is often thought desirable for a tax system to achieve a certain

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[17] Daniel Feenberg and James M. Poterba, "The Alternative Minimum Tax and Effective Marginal Tax Rates," *National Tax Journal*, vol. 57 part II, June 2004, p. 412.

level of fairness, both in horizontal terms (the equal treatment of individuals in different circumstances) and vertical terms (the relative treatment of individuals at different income levels). Further, economists argue that broad-based tax systems with low rates — a characteristic of the AMT — are less damaging to economic efficiency than higher-rate systems that apply to bases laden with special benefits. With the AMT, taxpayers can use the tax benefits available under the regular tax only up to a point, where considerations of equity and efficiency trigger applicability of the AMT: the benefits' economic growth and social goals are balanced with fairness and efficiency concerns. To the extent the AMT's growth has resulted from inflation and lack of indexation, it might be argued that the AMT's advance is unintended, and the balance between equity and social and economic goals intended for the AMT has been upset.[18]

A factor that substantially complicates the AMT issue is its revenue effect, which assumes increased prominence given current federal budget deficits. For example, indexing the AMT for inflation would eliminate much of the impetus of the tax's increasing applicability. According to Congressional Budget Office (CBO) indexing the AMT would reduce federal revenues by $385 billion over ten years, an amount equal to 1.3% of federal revenues expected over the period. If EGTRRA's tax cuts are extended or made permanent, the cost of restraining the AMT would be considerably larger, reducing revenue by $642 billion, or 2.1% of revenue.

For further information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein and CRS Report RS22100, *The Alternative Minimum Tax for Individuals: Legislative Initiatives and Their Revenue Effect*, by Gregg A. Esenwein.

## Tax Reform

There are indications that tax reform — either incremental changes to the current system or a more fundamental reform — may begin to be actively considered by Congress in 2006. President Bush, in his September, 2004, speech accepting the Republican nomination for President, called for reform whose goals would be simplification, fairness, and economic growth. In January, 2005, the President appointed an advisory panel to study the topic and report to the Secretary of the Treasury. The panel issued its report on November 1 (see below).

Numerous tax reform bills were introduced in the 108th Congress and a number of measures have been proposed thus far in the 109th Congress. In the 109th Congress, the content of the proposals ranges from plans for a flat-rate consumption tax (S. 1099) to a proposed national retail sales tax (H.R. 25/S. 25), to a bill that requires the Secretary of the Treasury to conduct an analysis of a transactions tax.

More generally, proposals for the general reform of the tax system have taken one of two conceptual forms: a tax on a comprehensive measure of income; or a tax

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[18] It might be argued that the level intended by Congress is that established under the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), where the permanent exemption levels and bracket amounts and rates were established.

on consumption. Both types of reform proposals typically involve broadening the tax base while reducing the tax rates that apply to the base. A comprehensive income tax would apply at the same rate to all income, regardless of its use or its source, thus eliminating many of the special deductions and credits contained in the current system. A consumption tax would only apply to that portion of income that is spent on consumption and would not apply to saving. Both types of reform are generally championed on grounds of economic efficiency — because they apply more evenly across different types of income, broad-based taxes are less distorting of economic decisions and thus permit a more smoothly working economy. Because consumption taxes do not apply to saving, their adherents argue that they better promote saving and investment and thus economic growth. Critics, however, are skeptical of how responsive savers actually are to the presence or absence of taxes and point to the greater difficulty in establishing progressivity under a consumption tax. Each type of tax reform is also frequently supported on grounds of simplicity; the substantial (and apparently growing) complexity of the current tax system is often cited as a primary reason for tax reform. Skeptics, however, point out that the three goals of most tax reform plans — economic performance, equity, and efficiency — are frequently at odds, so that even the most carefully-designed reform plan cannot achieve perfection in all three areas.

Like any thorough rearrangement of economic relationships, fundamental tax reform would produce complex transition effects and there would be both winners and losers across economic actors and taxpayers. For example, broadening of the base would necessarily entail elimination of a variety of deductions and credits favoring particular activities, investments, or types of income, and there are doubtless some who would lose more from the elimination of such preferences than they would gain from a reduction in statutory tax rates. And, in the case of a switch to a consumption tax, owners of existing capital — for example, owners of corporate stock — would register a windfall loss as a transition effect. These changes could also lead to inflation and recession, which could be serious for certain types of consumption taxes.

The complexity and magnitude of the transition effects suggest that if Congress does adopt fundamental tax reform, the path would be arduous and debate would be heated. To illustrate, Congress in the mid-1990s actively considered fundamental tax reform without adopting it: numerous reform bills were introduced and hearings were held by the tax-writing committees.[19] And even when tax reform has been achieved, it has eroded over time: the Tax Reform Act of 1986 (P.L. 99-514) was a substantial movement toward a reformed tax on comprehensive income. Over the past two decades, however, the grand compromise the act embodied — lower rates exchanged for fewer special tax benefits — has come unwound, suggesting the difficulty of crafting an enduring version of tax reform.

**The President's Advisory Panel on Tax Reform.** The advisory panel formed by President Bush in January 2005 conducted public hearings as well as

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[19] See, for example, U.S. Congress, House Committee on Ways and Means, *Replacing the Federal Income Tax*, 104th Cong., 1st sess., June 6, 7, and 8, 1995 (Washington: GPO, 1995), 1,055 pp.

closed meetings over the spring, summer, and fall of 2005. After several delays, the panel submitted its recommendations to the Secretary of the Treasury on the first day of November.

The panel proposed two alternative tax systems — what it termed the Simplified Income Tax Plan (SITP) and the Growth and Investment Tax Plan (GITP). Both systems, the panel stated, were designed to be roughly "revenue neutral" — raising as much added tax revenue as they would lose. Both systems would broaden the tax base by ending some individual income tax deductions — for example, the deduction for state and local income taxes — but would also retain revamped tax benefits in other areas — for example, for home ownership. Under both plans, personal exemptions, the standard deduction, and the child tax credit would be replaced with a new Family Credit that would vary in size, depending on filing status. Both systems would repeal the alternative minimum tax and would reduce statutory tax rates.

The two plans differ primarily in their treatment of business income and income from capital investment and saving. The SITP would retain the corporate income tax rate, but at a reduced rate and with a simplified method of accelerated depreciation. Also, income from U.S. firms' overseas operations would not be taxed, thus implementing a "territorial" tax system. Corporations would still be able to deduct interest. While the corporate-level tax would be retained, shareholders would not be taxed on dividends and would exclude 75% of capital gains from tax, while interest would still be taxed to individuals at regular tax rates. The system would thus move towards eliminating double-taxation of corporate-source income, moving towards a "full integration" system.

The GITP would retain the corporate income tax, but in altered form: it would permit firms to fully deduct ("expense") capital investment in the year of acquisition. Expensing is the mathematical equivalent of an exemption for income from new investment. Thus, the GITP would effectively do away with business tax on new investment; income from existing investment, however, would continue to be taxed. Interest would no longer be deductible at the corporate level. A destination-based "border tax adjustment" would be implemented similar to those used with value-added taxes: the tax on exports would be rebated but tax would be imposed on imports. Shareholders and corporate creditors would continue to be taxed on dividends and interest, albeit at a reduced (15%) rate. GITP thus partly removes current law's double-taxation of corporate-source income.

For additional information on tax reform in general, see CRS Report RL33443, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, by James M. Bickley; and CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Gregg Esenwein and Jane G. Gravelle. The details of the Tax Reform Advisory Panel's proposals are online at the panel's website, at [http://www.taxreformpanel.gov/final-report/].

## The Estate Tax

Under provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), the estate tax and generation-skipping transfer tax are scheduled to be repealed effective January 1, 2010. But the estate tax repeal, and all other provisions of EGTRRA, are scheduled to sunset December 31, 2010. If the sunset provision is not repealed, or the law is not otherwise changed beforehand, in 2011 estate and gift tax law will return to what it would have been had EGTRRA never been enacted. The unified estate and gift taxes will be reinstated with an exemption of $1 million. The maximum tax rate will revert to 55%.

Both before and after the enactment of EGTRRA, there have been efforts in Congress, primarily by Republicans, to make estate tax repeal permanent. The 106th Congress passed legislation that was vetoed by President Clinton in August 2000. In both the 107th and 108th Congresses, the House passed legislation making the repeal permanent, but the Senate did not. Democrats introduced bills, not enacted, that would have retained the estate tax but raised the applicable exclusion amount.

The Bush Administration's budget for FY2007 once again endorsed permanent repeal of the estate tax. On April 13, 2005, the House passed H.R. 8, a bill that would permanently repeal the estate tax starting in 2010. The House defeated the Pomeroy substitute amendment, which would have retained the estate tax with higher applicable exclusion amounts. Numerous other bills to repeal or alter the estate tax have been introduced in the 109th Congress. In June 2006, the Joint Committee on Taxation (JCT) estimated that enacting legislation in 2006 to make estate tax repeal permanent effective in 2010 would cost $387 billion in lost revenues over the 10-year forecast period FY2007-FY2016 (which includes five years of full repeal).

Following Hurricane Katrina, Senate Majority Leader Bill Frist cancelled a cloture vote scheduled for September 6, 2005, on a motion to proceed to consider H.R. 8. The Senate finally voted on cloture on June 8, 2006. The vote of 57-41 was three short of the 60 votes needed. Efforts continued on developing a compromise proposal. On June 16 Senator Frist proposed that the House pass a permanent estate tax reform compromise that could attract 60 votes in the Senate. His goal is to have the Senate vote on an estate tax measure before the July 4th recess begins. On June 19 House Ways and Means Committee Chairman William Thomas introduced H.R. 5638. The bill would restore the unified estate and gift tax exclusion and raise the exclusion amount to $5 million per decedent. Any unused exclusion could be carried over to the estate of the surviving spouse. The tax rate on taxable assets up to $25 million would be equal to the tax rate on capital gains (currently 15% but scheduled to revert to 20% in 2011). The tax rate on assets over $25 million would be twice the capital gains rate. The deduction for state death taxes would be repealed. These provisions would take effect in 2010. In addition, H.R. 5638 would create a new, temporary, 60% income tax deduction for qualified timber capital gains. The JCT estimates that the estate tax provisions of H.R. 5638 would cost $279 billion over FYs 2006-2016, or 72% as much as total repeal. The timber provisions would cost $940 million. On June 22 the House approved H.R. 5638 by a vote of 269-156.

This section was written by Nonna A. Noto. For more information, see CRS Report RL32818, *Estate Tax Legislation in the 109th Congres*s, by Nonna A. Noto.

## Taxes in the President's FY2007 Budget Proposal

On February 6, 2006, the Bush Administration released the details of its FY2007 budget proposals, including its tax proposals. In broad terms, the Administration proposed cutting taxes by $28 billion in FY2007 and by $280 billion over the five-year period FY2007-FY2011. Compared to baseline receipts — that is, receipts that are expected to occur if no changes are made to current law — the proposed reductions amount to 1.1% of receipts in FY2007 but grow to 4.9% in FY2011.

Extension of tax cuts that are scheduled to expire make up the largest part of the Administration's proposed tax cuts, both in the near term and the long run. In the very near term — for FY2007 — the budget proposes to extend alternative minimum tax relief for individuals (but only through 2006) and also several more narrowly focused tax benefits: an increased "expensing" investment allowance for small business, the research and experimentation tax credit, the work opportunity and welfare to work credits, and several other benefits. Together, the one-year revenue reductions from these items would account for an estimated 82% of all tax cut items proposed for FY2007.

The Administration also proposes to expand a set of tax cuts that were enacted in 2001 and 2003, but that are scheduled to expire in the longer term. These include tax cuts enacted under the Economic Growth Tax Relief and Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) that are scheduled to expire at the end of calendar year 2010: individual income-tax rate cuts, an increased child tax credit, tax cuts for married couples, and repeal of the estate tax. They also include reduced tax rates for capital gains and dividends that were enacted by the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) but that are scheduled to expire at the end of calendar year 2008.

Other prominent proposals in the budget are a set of expanded tax incentives for saving, tax benefits related to health care (including an expanded deduction and a tax credit for certain high-deductible health insurance premiums), and tax benefits for charitable giving.

## Major Tax Legislation, 2001-2004

### The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16)

On February 8, 2001, President Bush sent the outlines of a tax plan to Congress that was the same in its essentials to the tax proposal he advanced during the presidential campaign. According to Administration estimates, the tax cuts would reduce revenue by $1.6 trillion over 10 years. In the House, tax cuts similar to the President's proposals were passed in March, April, and early May as components of several different bills. The Senate passed a somewhat different tax cut plan in May, and on May 26, the House and Senate both approved a conference agreement on the bill, entitled the Economic Growth and Tax Relief Reconciliation Act of 2001. Although the congressional bill contained some differences from the President's plan, the President signed the measure on June 7; it became P.L. 107-16.

Timing was an important element of P.L. 107-16 in several ways. First, many of the act's most important provisions are "phased in"; that is, they become fully effective only gradually, over a number of years. Second, the act contained language providing for the expiration ("sunset") of its provisions after 2010. The provision was included because of Senate procedural rules on budget reconciliation. As noted elsewhere in this report, both Act's phase-in and sunset provisions have been a focus of congressional attention since EGTRRA's enactment. As enacted, EGTRRA was estimated to reduce revenue by $1.35 trillion over the period 2001-2011.

As with the President's plan, EGTRRA's centerpiece was a **reduction in the individual income tax rates** that apply to taxable income. Prior to the act, the tax code's rates were 15%, 28%, 31%, 36%, and 39.6%; the act reduces these to 10%, 15%, 25%, 31%, and 35%. In addition, the act eliminates the overall limit on itemized deductions and phases out the tax code's restriction on personal exemptions.

Under EGTRRA's phase-in schedule, the rate reductions were not scheduled to be fully effective until 2006. At the same time, the act's application of a 10% rate to the lowest part of the lowest bracket is retroactive to January 1, 2001 — a provision designed to provide an economic stimulus. Beginning in July, 2001, the Treasury Department issued checks based on the rate reduction.

The act increased the tax code's **per-child tax credit** from prior law's $500 to a new level of $1,000, phased in over the period 2001-2010. Also, under prior law, the child tax credit is refundable only for families with three or more children. The act extends refundability to smaller families, subject to certain limitations. The act also provided that the refundable child credit would not be reduced by a taxpayer's alternative minimum tax (AMT), and that the credit would offset both a taxpayer's AMT and regular tax.

EGTRRA provided **tax reductions for married couples**. Under prior law, certain structural features of the income tax could result in a married couple paying either more or less in tax than they would as two singles — incurring a "marriage penalty" or "marriage bonus," in tax parlance. Features responsible for the uneven treatment of marital status included the standard deduction, tax-bracket widths, and the earned income tax credit (EITC). EGTRRA addressed the marriage penalty by increasing the standard deduction for couples, widening the income bracket to which the 15% tax rate applies, and altering the EITC. As with the tax-rate reductions, the tax cuts for married couples were scheduled to be gradually phased in.

EGTRRA **phased out the federal estate tax** over the period 2002-2010. The phase-out consisted of a gradual reduction in estate tax rates over the phase-out period, as well as an increase in the effective exemption delivered by the estate and gift tax unified credit.

The act provided a temporary reduction in the individual **alternative minimum tax** by increasing its exemption by $2,000 in the case of single returns and $4,000 for joint returns for the years 2001 through 2004. The exemptions under prior law were $33,750 and $45,000, respectively.

Other provisions of the act included:

- several tax benefits for education, including more generous rules for education IRAs and tax-favored tuition savings plans; permanent extension of the exclusion for employer-provided education assistance; more generous rules for deductibility of student-loan interest; and a temporary deduction for qualified education expenses tax cuts for IRAs and pensions,
- more generous rules for the **adoption tax credit**,
- provision of a 25% tax credit for **employer-provided child care**; and
- an increase in the **dependent care tax credit**.

For further information, see CRS Report RL30973, *2001 Tax Cut: Description, Analysis, and Background*, by David L. Brumbaugh, Jane G. Gravelle, Steven Maguire, Louis Alan Talley, and Bob Lyke.

## Job Creation and Worker Assistance Act of 2002 (JCWA; P.L. 107-147)

The final version of the Job Creation and Worker Assistance Act was approved by Congress and signed into law in March, 2002, but the act grew out of tax proposals that began moving through both chambers in late 2001 — proposals designed to provide economic stimulus in the wake of the September, 2001, terrorist attacks. The enacted version of JCWA was considerably smaller than EGTRRA; the Joint Tax Committee estimated that it would reduce revenue by an estimated $12.9 billion over 10 years. Also in contrast to EGTRRA, the enacted version of JCWA focused more on business tax cuts than tax cuts for individuals.

The act's principal components were:

- A "bonus" depreciation allowance under which firms could deduct an additional 30% of the cost of property in its first year of service. The provision was temporary and limited to property placed in service before 2005.
- An extension of the net operating loss "carryback" period (the years in the past from whose income a firm can deduct losses) to five years from two years. The provision only applied to losses in 2001 and 2002. A set of business tax benefits targeted at areas of New York City.
- Extension of a set of expiring tax benefits (e.g., the work opportunity tax credit, the welfare-to-work tax credit, and extension of nonrefundable credits to the alternative minimum tax), generally through 2003.

## The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27)

On January 7, 2003, President Bush announced the details of a new tax cut proposal intended to provide a stimulus to the economy and to provide tax incentives in selected areas. According to the Joint Committee on Taxation, the revenue reduction from the plan was estimated at $1.575 trillion over FY2003-FY2013.

The President's proposal consisted of an economic stimulus component and a set of more narrow, targeted tax cuts. The stimulus portion consisted primarily of acceleration of several tax cuts for individuals that were enacted by EGTRRA in 2001 but that were scheduled to be phased in only gradually (see the preceding section on EGTRRA). The Administration proposed to make the reductions effective for 2003 rather than the scheduled phase-in dates. The proposed accelerations included tax rate reductions, tax cuts for married couples, and an increased child tax credit. Another prominent part of the President's 2003 plan was a proposal to move toward "integration" of the taxation of corporate-source income by eliminating individual income taxes on dividends and by permitting a "step up in basis" for capital gains resulting from retained earnings. The Administration also proposed to increase the "expensing" allowance for small business investment in equipment to $75,000 from current law's $25,000.

Prominent among the more targeted tax cuts proposed with the budget were two new tax-favored savings vehicles that would replace Individual Retirement Accounts (IRAs) and that would have less binding restrictions than current law's IRAs; a set of new tax incentives for charitable giving, including a deduction for non-itemizers; a number of tax benefits related to health care, including a long-term care insurance deduction for non-itemizers; a set of tax benefits related to energy production and conservation; and permanent extension of current law's temporary research and experimentation tax credit.

On May 23, 2003, the House and Senate agreed to the conference report for H.R. 2, the Jobs and Growth Tax Relief and Reconciliation Act (JGTRRA; P.L. 108-27). In broad outline, the act contained the principal elements of the stimulus part of the President's tax-cut proposal. The President signed the bill into law on May 28. JGTRRA's conference agreement contained an estimated $350 billion in reduced revenues and increased outlays from FY2003 through FY2013, including $320 billion in tax cuts and $30 billion in outlay increases. The principal outlay provisions in the package established a $20 billion fund to provide fiscal relief to state governments. The principal tax components of JGTRRA were:

- Acceleration to 2003 of the individual income tax cuts enacted and scheduled for phase-in under EGTRRA. EGTRRA had scheduled a gradual increase in the child tax credit from prior law's $500 to a level of $1,000 by 2010. JGTRRA provided for the $1,000 to be effective in 2003 and 2004, but its acceleration was temporary and provided for the credit to revert in 2005 to the lower, phase-in schedule provided by EGTRRA ($700 in 2005-2008, $800 in 2009, and $1,000 in 2010).

- For 2003 and 2004 only, the standard deduction and 15% tax brackets for married taxpayers were made twice those for singles. In a manner similar to the child credit, these provisions were scheduled to revert to EGTRRA's schedule beginning in 2005. The alternative minimum tax exemption amount was increased by $9,000 for married couples and $4,500 for singles for 2003 and 2004.
- The maximum expensing benefit for small business investment was temporarily increased from prior law's $25,000 to $100,000 for 2003, 2004, and 2005. The provision's phase-out threshold was increased from $200,000 to $400,000 over the same time period. The temporary "bonus" depreciation allowance originally passed in March 2002 was increased and extended to allow for a 50% first year deduction (up from 30%) for the period between May 5, 2003 and December 31, 2004.
- The conference agreement reduced the tax rate on both dividends and capital gains to 15% for taxpayers in the higher tax brackets and 5% for those in the lower tax brackets for 2003 through 2008. (The tax rate for those in the lower tax brackets would be 0% in 2008.) The dividend provision was applied to both domestic and foreign corporations.

For additional information, see CRS Report RL31907, *The 2003 Tax Cut: Proposals and Issues*, by David L. Brumbaugh and Don C. Richards.

## Working Families Tax Relief Act of 2004 (H.R. 1308; P.L. 108-311)

The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA) provided a number of substantial tax cuts that were scheduled to be phased in gradually over the 10 years following EGTRRA's enactment. As discussed more fully above (see the section on "Scheduled Expiration of Tax Cuts") the tax cuts are generally scheduled to expire at the end of 2010. In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) accelerated a number of EGTRRA's phased-in tax cuts, including reduction of individual income tax rates and tax cuts for married couples and families, making EGTRRA's cuts fully effective in 2003. However, JGTRRA's accelerations were themselves scheduled to expire at the end of 2004. A principal thrust of the Working Families Tax Relief Act (WFTRA) was to extend JGTRRA's tax cuts to the particular year in which EGTRRA's phased-in provisions are fully effective. The measure was approved by Congress on September 23, 2004, and was signed into law on October 4. According to Joint Tax Committee revenue estimates, WFTRA will reduce revenue by $132.8 billion over five years and $146.9 billion over 10 years.

WFTRA's provisions:

- extended the increased ($1,000) child tax credit;
- extended tax cuts for married couples;
- extended the widened 10% tax-rate bracket;

- extended the increased alternative minimum tax exclusion through 2005 and accelerated the refundability of the child tax credit to 2004; and
- included combat pay in income that qualifies for the refundable child tax credit and the earned income tax credit.

In addition to the expiring provisions of EGTRRA and JGTRRA, the tax code has long contained a set of additional temporary tax benefits that are generally designed to promote various types of investments and activities thought to be beneficial. Prominent examples include the research and experimentation tax credit, the work opportunities tax credit, and the welfare to work tax credit. WFTRA extended a number of these so-called "extenders," generally through 2005.

## The American Jobs Creation Act (H.R. 4520; P.L. 108-357)

Congress passed the American Jobs Creation Act (AJCA) in October, 2004. The principal concern of the bill was business taxation. The bill began as a remedy to a long-running dispute between the United States and the European Union over the U.S. extraterritorial income exclusion (ETI) tax benefit for exporters. The scope of the enacted bill, however, was considerably broader. In general outline, the act repealed ETI while implementing a mix of tax cuts for both domestic and multinational U.S. businesses. The act achieved estimated revenue neutrality with a set of provisions generally in the area of corporate tax compliance.

AJCA provisions are numerous and apply to a broad array of tax code sections. In general terms however, the act's most important provisions are:

- a repeal of the ETI export tax benefit;
- a variety of tax cuts generally favoring domestic (as opposed to foreign) investment (chief among these was a new 9% deduction limited to domestic production) and several tax cuts for multinational firms, including more generous foreign tax credit rules for the treatment of interest expense and a consolidation of the several separate foreign tax credit limitations that existed under prior law; and
- a set of revenue raisers (in addition to ETI's repeal) including provisions aimed at restricting corporate tax shelters, provisions designed to improve fuel tax compliance, and a provision restricting tax benefits available from lease transactions involving tax-indifferent entities.

For additional information on AJCA, see CRS Report RL32652, *The 2004 Corporate Tax and FSC/ETI Bill: The American Jobs Creation Act of 2004*, by David L. Brumbaugh.