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Temporary Tax Provisions (“Extenders”) Expired in 2005

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Summary

Several temporary tax provisions expired in 2005. Often referred to as “extenders,” these provisions were originally enacted with expiration dates that have subsequently been extended, in some cases numerous times. The temporary nature of extenders can be considered useful as it allows policymakers to evaluate the effectiveness of the provisions on a regular basis. If an extender is found to be ineffective, its scheduled expiration allows several policymaking options, including allowing the provision to expire or redesigning the provision to improve its use as a policy tool. However, policymakers have, for the most part, considered the extenders as a group during the enactment process, and have not reviewed the unique strengths and weaknesses of specific provisions. Treating permanent provisions as temporary masks their long-run budgetary cost and leads to uncertainty for taxpayers’ planning.

The extenders that have expired included tax credits, which are the Work Opportunity Tax Credit (WOTC), the Welfare-to-Work Tax Credit (WWTC), the New York WOTC, the credit for holders of qualified zone academy bonds, the research and experimentation tax credit, and the credit for first-time homebuyers in the District of Columbia. Two other tax credits are scheduled to expire this year and are included in this report: the New Markets Tax Credit and the possession tax credit with respect to American Samoa. The expired tax provisions included deductions which are for the expenses of elementary and secondary school teachers, corporate contributions of computer technology, costs of remediation of “brownfields,” contributions to Archer Medical Savings Accounts, capital investment in oil and gas produced from marginal wells, the state and local sales tax deduction, and several depreciation allowances. The depreciation allowances include an accelerated provision for property on Indian reservations, qualified leasehold improvements, and qualified restaurant improvements. Other temporary tax provisions that expired included tax incentives for investment in the District of Columbia Enterprise Zone, an increased “cover over” of tax on distilled spirits from Puerto Rico and the U.S. Virgin Islands, and an excise tax to induce parity in the application of certain mental health benefits.

Several proposals have been made in the 109th Congress to extend temporary tax provisions. In late 2005, proposals to extend certain expiring provisions were included in the tax reconciliation bills, H.R. 4297 and S. 2020. In the spring of 2006, those provisions were dropped from H.R. 4297 during its conference. It was announced that the provisions would be added during the conference for pension legislation, H.R. 2830. Instead, on July 28th, certain expired provisions were added to H.R. 5970 and passed in the House. H.R. 5970 was placed on the Senate calendar but several motions to proceed to consider the bill failed just before the August recess.

This report discusses the nature of extenders, as temporary provisions and as tax benefits. Descriptions of the extenders that expired in 2005 are included. This report will be updated as warranted by legislative events.

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Temporary Tax Provisions (“Extenders”) Expired in 2005

Several temporary tax provisions expired in 2005. Often referred to as “extenders,” these provisions were originally enacted with an expiration date that has then been temporarily extended, in some cases numerous times. The extenders provided special tax treatment for certain types of activities and investment; they benefitted both individuals and corporations. The extenders included credits, deductions, and other provisions.

The extenders that have expired included tax credits, which are the Work Opportunity Tax Credit (WOTC), the Welfare-to-Work Tax Credit (WWTC), the New York WOTC, the credit for holders of qualified zone academy bonds, the research and experimentation tax credit, and the credit for first-time homebuyers in the District of Columbia. Two other tax credits are scheduled to expire this year and, because of legislative interest, are included in this report: the New Markets Tax Credit and the possession tax credit with respect to American Samoa.

The expired tax provisions included deductions which are for the expenses of elementary and secondary school teachers, corporate contributions of computer technology, costs of remediation of “brownfields,” contributions to Archer Medical Savings Accounts, capital investment in oil and gas produced from marginal wells, the state and local sales tax deduction, and several depreciation allowances. The depreciation allowances include an accelerated provision for property on Indian reservations, qualified leasehold improvements, and qualified restaurant improvements.

Other temporary tax provisions that expired included tax incentives for investment in the District of Columbia Enterprise Zone, an increased “cover over” of tax on distilled spirits from Puerto Rico and the U.S. Virgin Islands, and an excise tax to induce parity in the application of certain mental health benefits.

Developments in the 109th Congress

In the fall of 2005, S. 2020 and H.R. 4297 were introduced. Among a variety of tax relief proposals, the bills proposed to extend certain expiring tax provisions. The bills proposed the extension of many of the same provisions, though S. 2020 would have extended provisions through December 31, 2007, whereas the provisions in H.R. 4297 would have been extended through December 31, 2006.

In December 2005, H.R. 4297 was passed in the House and sent to the Senate. The Senate stripped H.R. 4297 as passed in the House, added the tax provisions from

S. 2020, and passed H.R. 4297 in February 2006. During the conference, however, the extenders were dropped from the report and did not become part of the new tax law. Tax writers indicated that the expiring provisions would be added to the conference report for H.R. 2830, the pension bill that was scheduled for conference shortly after the passage of H.R. 4297. Late in July 2006, however, the expiring provisions were dropped from the pension bill's conference report. On July 28th, the House added the provisions to H.R. 5970, the Estate Tax and Extension of Tax Relief Act of 2006, and passed the legislation the next day.

Analysis

Several tax provisions expired in 2005, all of which have been extended at least twice since their original expiration date. Among the extenders, one provision was 20 years old, another was 10 years old, and nine other provisions had been in existence for five years or more. The durability of the extenders suggests they may be more than temporary in nature.

The analysis of temporary tax provisions is complex, involving the examination of issues of policymaking and economics. Tax incentives are designed to alter the behavior of those who are the intended beneficiaries. Economic analysis provides a framework to examine the success of temporary tax provisions in achieving their intended outcomes.

Extenders as Temporary Tax Provisions

The extenders are a recurring legislative issue because of their temporary nature. Each time an extender's expiration approaches, Congress faces the choice to extend the tax provision, redesign it, allow it to expire, or make it a permanent provision in the tax code. The reason for their temporary, yet normally extended character, may be, in part, tax revenue: temporary extensions have lower short-run revenue costs than permanent law, although the ostensible lack of permanence often masks the long-term costs associated with the provisions. Temporary tax provisions are often extended for one or two years at the most, and at the time of extension, the costs appear small enough to warrant nominal offsets as required under the pay-as-you-go rule.¹ Yet, increasingly, the provisions have been extended for five and 10 years and have long-term revenue losses similar to other permanent parts of the tax code.

Extenders, like all tax benefits, affect revenue estimating as well. Budget estimates are required to be made assuming current law proceeds uninterrupted. As a result, revenue projections are made assuming temporary tax provisions expire according to current law. Thus, if temporary provisions are frequently extended automatically, revenue projections may be inaccurate. An example that illustrates

¹ Pay-as-you-go (PAYGO) was a requirement established by the Budget Enforcement Act of 1990, which proposed that any new direct spending or decrease in revenues for a fiscal year must be fully offset with additional revenue or entitlement savings elsewhere. Originally enacted for fiscal years 1991 through 1995, PAYGO rules were extended twice and expired at the end of FY2002.

this point is when tax writers are looking for revenue offsets to balance tax cuts. In the 108th Congress, legislation (H.R. 6) proposed several incentives for energy production. Some of the cost of those incentives was intended to be offset by a \$10 billion increase in expected tax revenue for 2009 through 2014 from an ethanol tax credit set to expire in 2008. If the credit is extended rather than allowed to expire, the revenue projections for those years is overstated.²

It might also be argued that the temporary nature of the provisions is useful, quite apart from revenue considerations. The temporary nature of expiring provisions allows policymakers to evaluate their effectiveness and allow for reassessment of their value on a regular basis. In theory, extenders that fail to accomplish their purpose could be allowed to expire. Yet, only one extender, a corporate deduction for group legal services provided to employees, has been allowed to expire in the past 25 years. That provision expired in 1993.

If a provision is thought to be ineffective, a policy alternative to allowing temporary provisions to expire is to redesign them. As an example, Congress replaced the Targeted Jobs Tax Credit, which was enacted in 1978, with the Work Opportunity Tax Credit in the Small Business Job Protection Act of 1996, P.L. 104-188. The temporary credit was initially effective for one year and then reauthorized by the Taxpayer Relief Act of 1997, P.L. 105-34, which also modified the credit by shortening the eligibility time, changing the subsidy rate, and adding a new group to the eligible population.

The extenders were not originally enacted at the same time. Many originated in one of the tax bills enacted during the late 1990s, and some in the mid 1980s. While their origins differ, the provisions have increasingly been considered as a group. Several of the extenders that expired in 2005 had been most recently extended by the Working Families Tax Relief Act of 2004, P.L. 108-311. Some of those temporary provisions were the Work Opportunity Tax Credit (WOTC), the Welfare-to-Work Tax Credit (WWTC), the credit for holders of qualified zone academy bonds, the deduction for capital investment in oil and gas produced from marginal wells, and the “cover over” of tax on distilled spirits from Puerto Rico and the U.S. Virgin Islands. Of those provisions, six had been extended by the Tax Relief Extension Act of 1999 (TREA; P.L. 106-170). Three of the six temporary provisions had been originally enacted by the Taxpayer Relief Act of 1997 (TRA; P.L. 105-34). The three provisions were the Welfare-to-Work Tax Credit (WWTC), the credit for holders of qualified zone academy bonds, and the deduction for capital investment in oil and gas produced from marginal wells.

Each extender is unique and addresses a separate topic in the tax code. Consideration of them as a group may ignore some of the strengths and weaknesses specific to individual provisions. Ideally, the purpose of each expiring provision should be clear, as well as the appropriateness of using the tax code to subsidize the targeted objective as opposed to a direct subsidy. Additionally, the benefits of the provisions should be examined to determine if they outweigh the costs of the

² Martin Vaughan, “GOP Support Unclear for Thomas Tax Bill,” *Congress Daily*, AM Edition, [<http://nationaljournal.com/pubs/congressdaily/>], visited March 4, 2004.

provisions and to ensure that forgoing the tax revenue from the activity is justified relative to other policy goals.

Treating permanent provisions as temporary also leads to uncertainty for government and taxpayer planning and causes, in some cases, significant impacts. When taxpayers are uncertain whether temporary provisions will be extended, they may have difficulty making reliable and effective business plans. An example of government uncertainty involves state employment agencies that certify the workers who qualify for the Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit. If those credits are not extended, the state certification workers would need to be reassigned to other tasks. When the credits are reinstated, the states would have to reassign the workers a second time. Those workers would also face a backlog of pending certifications created during the lapse of the temporary provision.

Extenders as Tax Benefits

Temporary tax benefits are a form of federal subsidy that treats eligible activities favorably compared to others, and channels economic resources into qualified uses. Extenders influence how economic actors behave and how the economy's resources are employed. Like all tax benefits, economic theory suggests every extender can be evaluated by looking at the impact on economic efficiency, equity and simplicity. Temporary tax provisions may be efficient and effective in accomplishing their intended purpose, though not equitable. Alternatively, an extender may be equitable but not efficient. Policymakers may have to choose the economic objectives that matter most. Doing so on a case-by-case basis for extenders may prove to be the best option to achieve the desired results.

Efficiency. Extenders often provide subsidies to encourage more activity than would otherwise be undertaken. According to economic theory, in most cases an economy best satisfies the wants and needs of its participants if markets operate free from distortions by taxes and other factors. Market failures, however, may occur in some instances, and economic efficiency may actually be improved by tax distortions.³ Thus, the ability of extenders to improve economic welfare depends on whether or not the extender is remedying a market failure. According to theory, an extender lowers efficiency if it distorts behavior in the absence of a market failure.

If an extender addresses a market failure and thus improves economic efficiency, the effectiveness of extenders can also be determined by examining their success in causing the intended response, or degree of response, by recipients of the tax incentive. Tax provisions can be an effective way to achieve program goals when they provide benefits to the intended entities or induce desirable activities. An extender may not be effective if it subsidizes activities that would have been undertaken in the absence of the tax incentive or if the activities undertaken are not the intended activities targeted by the tax incentive.

³ Market failure occurs when the marginal benefit of an action does not equal the marginal cost. For example, polluting forms of energy production cause social costs that are not taken into account by the producer; hence, there is an argument for taxing this type of energy or, alternatively, subsidizing less polluting firms.

An extender is also considered effective to the degree that it stimulates the desired activity better than a direct subsidy. Direct spending programs are often more successful at targeting resources than indirect subsidies made through the tax system.

Fairness. A tax is considered to be fair when it contributes to a socially desirable distribution of the tax burden. Tax benefits such as the extenders can result in individuals with similar incomes and expenses paying differing amounts of tax, depending on whether they engage in tax subsidized activities. This differential treatment is a deviation from the standard of horizontal equity, which requires that people in equal positions should be treated equally.

Another component of fairness in taxation is vertical equity, which requires that tax burdens be distributed fairly among people with different abilities to pay. Most extenders benefit those who have sufficient income to pay tax. Those individuals without sufficient income to pay tax do not have the opportunity to benefit from extenders. The disproportionate benefit of tax expenditures to individuals with higher incomes reduces the progressivity of the tax system, which is often viewed as a reduction in equity.

An example of the effect a tax benefit can have on vertical equity violation can be seen by identifying two individual teachers who have both incurred \$250 in classroom-related expenses and are eligible to claim the above-the-line deduction for expenses. Yet the tax benefit to the two differs if they are in different tax brackets. A teacher with lower income, who may be in the 15% income tax bracket, receives a deduction with a value of \$37.50, while another teacher, in the 31% bracket, receives a deduction value of \$77.50. Thus, the higher income taxpayer, with presumably greater ability to pay taxes, receives a greater benefit than the lower income taxpayer.

Simplicity. Extenders contribute to the complexity of the tax code and raise the cost of administering the tax system. Those costs, which can be difficult to isolate and measure, are rarely included in the cost-benefit analysis of temporary tax provisions. The complexity of the tax code adds to the time cost of taxpayers in either learning how to claim various incentives and doing so, or an increased direct cost of paying tax professionals to perform the service for the taxpayer.

Expired Temporary Tax Credits

Some of the extenders that expired in 2005 included several employment credits, the credit for holders of qualified zone academy bonds, the credit for first-time homebuyers in the District of Columbia, and the research and experimentation tax credit.

Table 1. Tax Credits

Provision	Internal Revenue Code Section
Work Opportunity Tax Credit	51(c)(4)
Welfare-to-Work Tax Credit	51A(f)
Indian Employment Tax Credit	45A(f)
Credit for holders of qualified zone academy bonds	1397E(e)(1)
Tax credit for first-time D.C. homebuyers	1400C(i)
Tax credit for research and experimentation	41(h)
New Markets Tax Credit*	45(d)
Possession Tax Credit with respect to American Samoa*	27(b), 936

Note: These two tax credits have not yet expired but have been included in the legislative proposals to extend temporary tax provisions, and are therefore included in this report.

Employment Tax Credits

Several temporary tax credits were enacted to lower the relative cost of hiring targeted group members by subsidizing their wages, increasing employers' willingness to hire them despite their presumed lower productivity. Current law provides several separate credits, but they are the statutory descendent of a single provision — the Targeted Jobs Tax Credit — that was first enacted in 1978. While the credits targeted similarly situated populations, their benefits to employers differed slightly.

Work Opportunity Tax Credit (WOTC). This credit is available for wages paid by employers who hired individuals from certain targeted groups. The WOTC was taken for first-year wages paid to eligible individuals who begin work after September 30, 1996, and before January 1, 2006. The credit amounts to 40% of the first \$6,000 of wages (or the first \$3,000 of wages for qualified summer youth employees) paid to each targeted group member during the first year of employment, and 25% in the case of wages attributable to individuals meeting only minimum employment levels. An employee must have completed a minimum of 120 hours of service for the wages to be taken into account for calculation of the credit. Individuals who fit into one of the following target groups qualify for the WOTC: qualified IV-A or Temporary Assistance to Needy Families (TANF) recipients, qualified veterans, qualified ex-felons, high risk youth residing in an empowerment zone, enterprise community, or renewal community, vocational rehabilitation referral, qualified summer youth employees, qualified food stamp recipients, or qualified Supplemental Security Income recipients.

Welfare-to-Work Tax Credit (WWTC). This nonrefundable credit is available to private sector, for-profit employers who hire long-term recipients of TANF benefits. During the first year in which WWTC-eligible persons were hired,

employers can claim an income tax credit of 35% of the first \$10,000 earned by the employee. The employer can claim an income tax credit of 50% of the first \$10,000 in earnings during the second year of their employment. In addition to gross wages, certain tax-exempt amounts received under accident and health plans, as well as under educational or dependent assistance programs, qualify for this subsidy rate. The maximum amount of the credit an employer can claim is \$3,500 per worker in the first year of employment and \$5,000 per worker in the second year of employment. An employer's usual deduction for wages has to be reduced by the amount of the credit and the credit could not exceed 90% of an employer's annual tax liability. Employers cannot claim the WOTC and WWTC for the same individuals.

The eligible group is defined as members of a family that received benefits for at least 18 consecutive months ending on the hiring date, members of a family that received benefits for a total of 18 (not necessarily consecutive) months beginning after August 5, 1997 (the date of the credit's enactment), members of a family that was no longer eligible for assistance after August 5, 1997, because of any federal- or state-imposed time limit (if they were hired within two years after the date the benefit ceases).⁴

H.R. 5970 proposes a one-year extension of both credits, through December 31, 2006, and then a combination and modification of the two credits followed by an extension through December 31, 2007.

Indian Employment Tax Credit. A nonrefundable credit is available to employers for the first \$20,000 of certain wages and health insurance costs paid for qualified employees through December 31, 2005. Qualified employees must be enrolled members of an Indian tribe or their spouses and can be full- or part-time employees. They must also perform a substantial amount of their services to the employer within an Indian reservation, and the principal place of residence of the employee while performing services for the employer must be on or near the reservation on which the services are performed. Qualified wages are wages paid or incurred by an employer for services performed by a qualified employee. Wages are excluded if they qualify for the Work Opportunity Tax Credit.⁵

The Indian employment credit was enacted by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) and extended twice, by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-47) and the Working Families Tax

⁴ For more detailed information on both the Work Opportunity Tax Credit and the Welfare-to-Work Credit, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC) and the Welfare-to-Work (WtW) Tax Credit*, by Linda Levine.

⁵ The Work Opportunity Tax Credit (WOTC) is an extender that expired in 2003 and, in October 2004, was retroactively extended through December 31, 2005. The WOTC is available for wages paid by employers who hired individuals from certain targeted groups. Individuals who fit into one of the following target groups qualify for the WOTC: qualified IV-A or Temporary Assistance to Needy Families (TANF) recipients, qualified veterans, qualified ex-felons, high risk youth residing in an empowerment zone, enterprise community, or renewal community, vocational rehabilitation referral, qualified summer youth employees, qualified food stamp recipients, or qualified Supplemental Security Income recipients.

Relief Act of 2004 (P.L. 108-311). H.R. 5970 proposes a two-year extension of the tax credit, through December 31, 2007.

Tax Credit for Holders of Qualified Zone Academy Bonds

Qualified Zone Academy Bonds (QZAB), which were first introduced as part of the Taxpayer Relief Act of 1997 (P.L. 105-34), are a type of bond that offers the holder a nonrefundable federal tax credit instead of interest. Qualified zone academies are public schools and programs that provide education and training below the post-secondary level. Issuers of QZABs are required to use the proceeds to finance public school partnership programs in economically distressed areas. QZAB holders are limited to banks, insurance companies, and corporations actively engaged in the business of lending money.

Initially, state and local governments could issue QZABs only in 1998 and 1999, subject to a national limitation of \$400 million each year. The Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106-170, extended this provision, authorizing up to \$400 million of QZABs to be issued in each of 2000 and 2001, with any unused authority carried over for several years. The Job Creation and Worker Assistance Act of 2002, (P.L. 107-47), extended the QZAB program with an additional \$400 million of bond capacity available for 2002 and 2003. The Working Families Tax Relief Act of 2004 (P.L. 108-311) authorized an additional extension through December 31, 2005.⁶ H.R. 5970 proposes a two-year extension of the provision, through December 31, 2007.

Tax Credit for First-Time Homebuyers in the District of Columbia

This credit allows a nonrefundable credit against federal taxes of up to \$5,000 for the first-time purchase of a principal residence in the District of Columbia. The credit is available only once for homebuyers who acquire title to a qualifying principal residence after August 1997 and before December 31, 2005. The tax credit was created by the Taxpayer Relief Act of 1997 (P.L. 105-34) to provide an incentive to purchase a home in DC, thus increasing the rate of owner-occupied home ownership. Compared to neighboring Maryland (70.7%) and Virginia (75.1%), the District of Columbia's home ownership rate is significantly lower (42.7%).⁷

The credit was most recently extended by the Working Families Tax Relief Act of 2004 (P.L. 108-311). H.R. 5970 proposes a two-year extension of the tax credit, through December 31, 2007.

⁶ For more detailed information, see CRS Report RS20606, *Qualified Zone Academy Bonds: A Brief Explanation*, by Steven Maguire.

⁷ U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107th Cong., 2nd sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 213-215.

Tax Credits for Research and Experimentation Expenses

A business credit for research expenses is available as a subsidy for research and experimentation (R&E) expenses paid or incurred through December 31, 2005. Under IRC section 41, the regular tax credit is generally equal to 20% of a firm's qualified research expenses above a base amount. This incremental design is intended to encourage firms to increase spending on R&D more than they otherwise would from one year to the next by lowering the after-tax cost of this added R&D spending.

The R&E tax credit, originally enacted in the Economic Recovery Tax Act of 1981 (P.L. 97-34), has been extended 11 times, most recently by the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) and by the Working Families Tax Relief Act of 2004 (P.L. 108-311).⁸ H.R. 5970 proposes a two-year extension of the tax credit, through December 31, 2007, and a one-year modification and enhancement of the credit rules.

New Markets Tax Credit

The New Markets Tax Credit (NMTC) program permits taxpayers to receive a credit against federal income taxes for making qualified equity investments in designated Community Development Entities (CDEs). Substantially all of the qualified equity investment must in turn be used by the CDE to provide investments in low-income communities. The credit provided to the investor totals 39% of the cost of the investment and is claimed over a seven-year credit allowance period. In each of the first three years, the investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is 6% annually. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period.⁹

The NMTC program was added by the Community Renewal Tax Relief Act of 2000, P.L. 106-554, and allows a maximum annual amount of qualified equity investments of \$3.5 billion per year for 2006 and 2007. H.R. 5970 proposes to extend the \$3.5 billion annual allocation through 2008.

Possession Tax Credit with Respect to American Samoa

Section 936 of the Internal Revenue Code allows certain domestic corporations with business operations in the U.S. possessions, including, among other places, American Samoa. The tax credit is intended to offset the U.S. tax imposed on certain income related to operations in American Samoa. Income eligible for the section 936

⁸ For more detailed information on the Research and Experimentation Tax credit, including its design, legislative history, effectiveness, and key policy issues, see CRS Report RL31181, *Research Tax Credit: Current Status, Legislative Proposals in the 109th Congress, and Policy Issues*, by Gary Guenther.

⁹ U.S. Department of the Treasury, Community Development Financial Institutions Fund, New Markets Tax Credit Program, website, [http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=5], visited June 22, 2006.

credit includes non-U.S. source income from the active conduct of a trade or business within a U.S. possession, the sale or exchange of substantially all of the assets that were used in such a trade or business, or certain possessions investments. The section 936 credit expired for taxable years beginning after December 31, 2005.

American Samoa has a tax system that mirrors U.S. tax law. Residents of American Samoa are taxed by both the United States and American Samoa. Nonresidents are taxed by American Samoa on their American Samoa-source income and income effectively connected with an American Samoa trade or business. American Samoa corporations are subject to U.S. tax on income effectively connected to a U.S. trade or business, and, in some cases, on passive income from U.S. sources and on U.S. branch profits.

To qualify for the possession tax credit for a taxable year, a domestic corporation must satisfy two conditions. First, at least 80% of the gross income of the corporation for the three-year period immediately preceding the close of the taxable year must be derived from sources within American Samoa. Second, the corporation must derive at least 75% of its gross income for that same period from the active conduct of a possession business.

The House-passed version of H.R. 4297 proposed to extend the section 936 credit for one year as applied to American Samoa. The proposal would allow existing credit claimants to claim the credit for income activities in taxable years beginning on or before December 31, 2006. The provision was not included in the Senate version of H.R. 4297.

H.R. 5970 proposes to extend the credit through December 31, 2007.

Expired Temporary Tax Deductions

Some of the expired tax deductions include provisions for individuals and corporations. These extenders include deductions for: expenses of elementary and secondary school teachers, corporate contributions of computer technology, costs of remediation of "brownfields," contributions to Archer Medical Savings Accounts, and capital investment in oil and gas produced from marginal wells.

Table 2. Tax Deductions

Provision	Internal Revenue Code Section
Expense deduction for elementary and secondary school teachers	62(a)(2)(D)
Deduction for tuition and related expenses	222
Enhanced deduction for corporate contributions of computer equipment for educational purposes	170(e)(6)(G)
Expensing of “brownfields” environmental remediation costs	198(h)
Contributions to Archer medical savings accounts	220(i)
Suspension of income limitation on percentage depletion for oil and gas from marginal wells	613A(c)(6)(H)
Deduction of state and local sales taxes	164
15-year straight-line cost recovery for qualified leasehold improvements	168(e)(3)(E)(iv)
15-year straight-line cost recovery for qualified restaurant improvements	168(e)(3)(E)(v)
Accelerated depreciation for property on Indian Reservations	168(j)

Expense Deduction for Elementary and Secondary School Teachers

An above-the-line deduction (i.e., a deduction for non-itemizers) for certain classroom expenses paid or incurred during the school year by eligible elementary and secondary school (K-12) teachers, among other educators, was authorized in the Job Creation and Worker Assistance Act of 2002. The provision, effective for taxable years beginning after December 31, 2001, and before January 1, 2006, allows for up to \$250 annually of expenses paid or incurred for books, supplies, computer equipment, and supplementary materials to be deducted. Under previously expired law, teachers were allowed to deduct these expenses only when itemizing on the tax return and (as with other deductions) only if the total of all itemized deductions exceeded 2% of adjusted gross income.¹⁰

H.R. 5970 proposes to extend the deduction for two years, through December 31, 2007.

¹⁰ For more detailed information see CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers* by Linda Levine.

Deduction for Tuition and Related Expenses

In June 2001, as a part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), Congress passed a new set of rules regarding the deductibility of higher education expenses. Starting in 2002, a new deduction was created for post-secondary education expenses paid by taxpayers for themselves, their spouse, or dependents. This “above-the-line” deduction was for tuition and education-related expenses paid for enrollment at any accredited post-secondary institution. This temporary tuition deduction, available during tax years 2002 through 2005, was available to taxpayers regardless of whether they claimed the standard deduction or itemized deductions when filing their income tax return. The deduction was not restricted by the overall limitation on itemized deductions.

The “above-the-line” deduction was limited to \$3,000 for 2002 and 2003. The deduction was limited to \$4,000 for 2004 and 2005. It was generally available to taxpayers with adjusted gross incomes below \$65,000 (\$130,000 for married individuals filing jointly). For 2004 and 2005 the maximum that could be deducted was either \$2,000 or \$4,000 depending on adjusted gross income. If adjusted gross income was \$65,000 or less (\$130,000 or less for those filing a joint return), the maximum deduction was \$4,000. If adjusted gross income was more than \$80,000 (\$160,000 for married individuals filing jointly), the deduction could not be claimed.

Only certain higher education expenses were allowable for deduction. For example, tuition and fees required for enrollment or attendance at an eligible post-secondary educational institution were allowable. However, taxpayers were required to subtract any scholarships, educational assistance allowances, or other nontaxable sources of income spent for educational purposes from the tuition and fees expense. This reduced amount was the qualified amount eligible for the deduction. Personal expenses and the cost of books were not allowable. Taxpayers could not claim a course involving sports, games, or hobbies, unless such course is part of the student’s degree program.

The income tax code disallows education expenses claimed for certain tax incentive programs to be claimed for the deduction as well. Any qualified education expenses deducted as a business expense, claimed for an education tax credit, or paid with earnings from either a Coverdell education savings account or U.S. education savings bonds, could not be claimed for the “above-the-line” tuition and fees deduction.

Additionally, the use of the deduction is conditional on the tax status of the student in relationship to the taxpayer. If the taxpayer claims an exemption for a dependent who is an eligible student, the taxpayer can include expenses paid for the student in determining the deduction. If the dependent pays the qualified expenses and the taxpayer claims an exemption for that student, neither the taxpayer nor the dependent can deduct the expenses.

H.R. 5970 proposes to extend the deduction for two years, through December 31, 2007.

Enhanced Deduction for Corporate Charitable Contributions of Computer Technology

Section 170(e)(6) of the Internal Revenue Code allows for an enhanced deduction for corporate contributions of computer equipment to public libraries and elementary and secondary schools. Generally, tax law allows for certain contributions of inventory or other ordinary-income property, and short-term capital gain property to be made by C (ordinary) corporations (S corporations, which are taxed as partnerships, are not eligible). In the case of charitable contributions, the amount of the deduction is limited to the taxpayer's basis (original investment) in the property. Special rules provide enhanced deductions for certain corporate contributions of inventory property for the care of the ill, the needy or infants and certain contributions of scientific equipment. Under these special rules, the amount of the enhanced deduction is equal to the donor's basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold.

Congress extended this special rule to provide an incentive for businesses to donate their computer equipment for the benefit of primary and secondary school students. Computer equipment includes computer software, computer or peripheral equipment, and fiber optic cable related to computer use. In addition to the augmented deduction benefit, the donor, by not selling the property, avoids realizing any capital gains and the subsequent income tax on those gains.

Originally authorized by the Taxpayer Relief Act of 1997 (P.L. 105-34), the provision was then extended for three years by the Community Renewal Tax Relief Act of 2000 (CRTRA; P.L. 106-554). CRTRA also expanded the deduction to include property donated to public libraries, property donated no later than three years (instead of two) after the date of taxpayer acquisition, and property donated after reacquisition by computer manufacturers. The most recent extension, through December 31, 2005, was authorized by the Working Families Tax Relief Act of 2004 (P.L. 108-311).

H.R. 5970 proposes to extend the deduction for two years, through December 31, 2007.

Expensing of "Brownfields" Environmental Remediation Costs

Section 198 of the Internal Revenue Code was created by the Taxpayer Relief Act of 1997, P.L. 104-34, to allow firms that undertake certain expenditures to deduct those costs against income in the year incurred. The allowable expenditures were those made to control or abate hazardous substances in a qualified contaminated business property. These expenditures would have otherwise been allocated to a capital account and could have been deducted only at some later point — for example, when the land was sold.

Expensing, or deducting against income, provides a tax subsidy for capital invested by business. By expensing hazardous control and abatement costs rather

than capitalizing those costs, taxes on the income generated by the expenditures were effectively zero. This provision provides a financial incentive to businesses and encouraged them to invest in the clean up and redevelopment of “brownfields,” which are abandoned industrial sites and dumps that would be cleaned up and redeveloped except for the prohibitive costs and complexities of environmental contamination.¹¹

The provision, which has been extended three times, by the Tax Relief Extension Act of 1999, P.L. 106-170; the Community Renewal Tax Relief Act of 2000, P.L. 106-554; and the Working Families Tax Relief Act of 2004, P.L. 108-311, required that eligible expenditures be incurred before January 1, 2006.

Both the House and Senate versions of H.R. 4297 as well as H.R. 5970 propose to extend the provision for two years through December 31, 2007, and to expand the definition of hazardous substance to include petroleum products, which include crude oil, crude oil condensates, and natural gasoline.¹²

Contributions to Archer Medical Savings Accounts

Archer Medical Savings Accounts (MSAs) are tax-advantaged personal savings accounts used for unreimbursed medical expenses. MSAs were first authorized by the Health Insurance Portability and Accountability Act of 1996 (HIPPA; P.L. 104-91). Individuals’ contributions are deductible from gross income up to an annual limit of 65% of the insurance deductible or earned income, whichever is less. Earnings on account balances are not taxed. These accounts are designed to encourage individuals to purchase high-deductible health insurance and to maintain a reserve for routine and other unreimbursed health care expenses. Contributions are allowed only if individuals are covered by a high-deductible health plan and no other insurance.

Archer MSAs were initially introduced as Medical Savings Accounts (MSAs) and later renamed by the Community Renewal Tax Relief Act of 2000, P.L. 106-554. MSAs were intended to slow the growth of health care costs, which had, at that time, exceeded the general rate of inflation for many years. By creating these accounts and giving consumers a larger financial stake in purchasing health care, policy makers were attempting to reduce third-party payments which were perceived to lower the effective price of health care to individuals and lead to excessive use. High-deductible insurance, by requiring consumers to assume more of the initial costs incurred each year, might have encouraged more prudent choices.

¹¹ For more details, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107th Cong., 2nd sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 325-327

¹² U.S. Congress, Joint Committee on Taxation, *Description of H.R. 4297, A Bill to Provide for Reconciliation Pursuant to Section 201(b) of the Concurrent Resolution on the Budget for Fiscal Year 2006*, 109th Cong., 2nd sess., JCX-75-05 (Washington: GPO, 2005), p. 35.

Archer MSAs have not attracted many participants. The number of existing Archer MSAs has never come close to the limit of 750,000 accounts. In October 2002, the IRS estimated that there would be 78,913 Archer MSA returns filed for tax year 2001; it also determined that 20,592 taxpayers newly established Archer MSA accounts in 2002. This low participation rate may have been influenced by several factors. Archer MSAs may not have appealed to certain categories of individuals. Those with chronic illnesses were more likely to desire low-deductible health plans that would have been ineligible for the program. Low-income individuals, being unwilling to incur high out-of-pocket costs, may have chosen low-deductible health plans. Additionally, individuals with other health plan options through their employer or community would not be eligible to participate.¹³

After 2002, no new contributions were to be made to Archer MSAs, except by or on behalf of individuals who previously made Archer MSA contributions, by employees of small employers, and by self-employed individuals with prior Archer MSA participation. Thus, taxpayers who participated in the programs could continue, but no new accounts could be opened. The Job Creation and Worker Assistance Act of 2002, P.L. 107-147, extended this provision for an additional year through December 31, 2003. The most recent extension, through December 31, 2005, was authorized by the Working Families Tax Relief Act of 2004 (P.L. 108-311).

H.R. 5970 proposes to extend the deduction for two years, through December 31, 2007.

Special Rules for Deduction for Oil and Gas from Marginal Wells

Firms that extract oil and gas were permitted an income tax deduction to recover their capital investment. That income tax deduction was determined using a method of percentage depletion, which was based on a fixed percentage of gross income. Among the limitations that apply in calculating percentage depletion deductions is a restriction that the amount deducted may not exceed 100% of the net income from oil and gas properties in any one year. Special percentage depletion rules applied to oil and gas production from marginal properties. One special rule, section 613A(c)(6) of the Internal Revenue Code, suspended the 100% of net income limitation as applied to domestic oil and gas production from marginal properties.

This tax incentive, designed to be a production subsidy, was criticized by some observers as inefficient. As a subsidy, the incentive was intended to increase investment exploration and output. In the short-run, it may have some impact on reducing dependence on imported oil. In the long-run, critics maintain that the

¹³ For more detailed information, see CRS Report RS21573, *Tax-Advantaged Accounts for Health Care Expenses: Side-by-Side Comparison*, by Bob Lyke and Chris Peterson.

provision may have contributed to a faster depletion of resources by encouraging swift development of existing properties.¹⁴

Initially enacted by the Taxpayer Relief Act of 1997, P.L. 104-34, the 100% taxable income limitation suspension has been extended three times, by the Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106-170; by the Job Creation and Worker Assistance Act of 2002. The most recent extension, through December 31, 2005, was authorized by the Working Families Tax Relief Act of 2004 (P.L. 108-311).

H.R. 5970 proposes to extend the deduction for two years, through December 31, 2007.

State and Local Sales Tax Deduction

For taxable years beginning in 2004 and 2005, at the election of the taxpayer, an itemized deduction could be claimed for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. Enacted by the American Jobs Creation Act of 2004 (P.L. 108-357), the itemized deduction included individual income taxes, real property taxes, and personal property taxes paid by the taxpayer. The itemized deduction was not allowable against the alternative minimum tax.

Taxpayers had two options with respect to the determination of the sales tax deduction amount. Taxpayers could deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers could use allowable deduction tables created by the Secretary of the Treasury. The tables are based on average consumption by taxpayers on a state-by-state basis taking into account filing status, number of dependents, adjusted gross income, and rates of state and local general sales taxation.

The term “general sales tax” means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of certain items, like food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items. The fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate.

The House-passed version of H.R. 4297 proposed to extend the deduction for one year by allowing taxpayers to elect to deduct state and local sales taxes in lieu of state and local income taxes through taxable years beginning on or before December 31, 2006. H.R. 5970 proposes to extend the deduction for two years, through December 31, 2007.

¹⁴ For more detailed information see CRS Report RL32265, *Expired and Expiring Energy Tax Incentives*, by Salvatore Lazzari.

Depreciation Allowances

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business, or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the tax code's modified accelerated cost recovery system (MACRS). Under MACRS, the cost of eligible property is recovered over specific periods of time (recovery periods), depending upon the type of property, and at specified rates over the prescribed recovery periods.

The tax code allows depreciation allowances for improvements made on leased property and typically requires the use of MACRS to determine the actual amount of depreciation even if the MACRS recovery period assigned to the property is longer than the term of lease. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period. However, exceptions exist for certain qualified leasehold improvements and certain qualified restaurant property.

15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements. In the case of qualified leasehold improvement property, Section 168(e)(3)(E)(iv) of the Internal Revenue Code allows a 15-year recovery period for property placed in service before January 1, 2006. Property placed in service after that date and later is subject to the rules described above. Qualified leasehold improvement property is any improvement to an interior portion of a nonresidential building. The improvement must be placed in service more than three years after the date the building was first placed in service.

15-Year Straight-Line Cost Recovery for Qualified Restaurant Improvements. In the case of qualified restaurant property, Section 168(e)(3)(E)(v) of the Internal Revenue Code allows a 15-year recovery period for property placed in service before January 1, 2006. Property placed in service after that date and later is subject to the rules described above. Qualified restaurant property includes any improvement to a building where more than 50% of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. The improvement must be placed in service more than three years after the date the building was first placed in service.

H.R. 5970 proposes to extend the provisions to apply to property placed in service through December 31, 2007.

Acceleration for Property on Indian Reservations. A temporary tax provision allows for the accelerated depreciation of qualified Indian reservation property that is placed in service after 1993 and before January 1, 2005. For business property on Indian reservations, IRC Section 168(j) allows for a shorter recovery period than is provided for under MACRS standards. The shorter periods applicable for Indian reservations are indicated below.

MACRS Standard	Applicable Period for Indian Reservations
3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

The accelerated depreciation provision requires that property be used in the active conduct of business within an Indian reservation. The provision was enacted by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) and extended by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-47).

H.R. 5970 proposes a two-year extension of the accelerated provision through December 31, 2007.

Other Tax Provisions

District of Columbia Enterprise Zone

The District of Columbia (DC) Enterprise Zone includes the DC Enterprise Community and the census tracts in the District of Columbia with a poverty rate of at least 20%. Businesses in the DC Zone are eligible for the following tax benefits: 1) a wage credit equal to 20% of the first \$15,000 in annual wages paid to qualified employees who resided within the District of Columbia; 2) \$35,000 in increased section 179 expensing; and 3) in certain circumstances, tax-exempt bond financing. Additionally, a capital gains exclusion is allowed for certain investments in small business stock held more than five years and made within the DC Zone, or within any District of Columbia census tract with a poverty rate of at least 10%.¹⁵ The DC Zone incentives, created in the Taxpayer Relief Act of 1997 (P.L. 105-34), were applicable from January 1, 1998 through December 31, 2003 and then extended through December 31, 2005.

H.R. 5970 proposes to extend the provisions through December 31, 2007.

¹⁵ For more details, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107th Cong., 2nd sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 317-320.

“Cover Over” of Tax on Distilled Spirits to Puerto Rico and the U.S. Virgin Islands

In general, federal excise taxes do not apply to items produced and consumed in Puerto Rico, the U.S. Virgin Islands (USVI), and other U.S. possessions. However, so that goods produced in the possessions do not have a tax-induced price advantage in U.S. markets over goods produced in the mainland, an “equalization tax” is levied on goods imported into the United States from Puerto Rico or the USVI. The tax is equal to the excise tax that applies to like items of domestic manufacture. That tax is then rebated or “covered over” to the Puerto Rico and USVI. The amounts covered over to Puerto Rico and the USVI are deposited into the treasuries of the two possessions for use as those possessions determine. The provision was granted because Congress believed that rebating the increased rate of tax would contribute to the economic stability of Puerto Rico and the USVI.¹⁶

In 1984, the Deficit Reduction Act, P.L. 98-369, increased excise taxes on U.S. distilled spirits to \$12.50 from \$10.50 per proof gallon; subsequent legislation increased the rate to \$13.50. However, the 1984 Act also amended the Internal Revenue Code, section 7652, by adding subsection (f) which initially imposed a \$10.50 limitation on “cover over” of the tax on distilled spirits. In 1993, the Omnibus Reconciliation Act, P.L. 103-66, extended the limitation such that the cover over amount was increased to \$11.30 per gallon effective for the five-year period beginning October 1, 1993. The Tax Relief Extension Act of 1999, P.L. 106-170, extended the amendment for an additional two years, increasing the rate to \$13.25 and the Job Creation and Worker Assistance Act of 2002, P.L. 107-147, provided a second extension effective through December 31, 2003. A third extension was authorized by the Working Families Tax Relief Act of 2004, P.L. 108-311, which made the provision effective through December 31, 2005.

H.R. 5970 proposes a two-year extension of the \$13.25 per proof gallon cover amount for rum brought into the United States through December 31, 2007. After that date, the cover amount would revert to \$10.50 per proof gallon.

Parity in the Application of Certain Mental Health Benefits

The Taxpayer Relief Act of 1997 (P.L. 105-34) imposed an excise tax on group health plans that fail to meet the requirements of the Mental Health Parity Act of 1996 (Title VII of P.L. 104-204). The Mental Health Parity Act requires group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not also imposed on substantially all medical and surgical benefits.

The excise tax is equal to \$100 per day during the period of noncompliance and is imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10% of the employer’s group health plan expenses for the prior year or \$500,000.

¹⁶ U.S. House Committee Report to H.R. 3090, H.Rept. 107-251, Oct. 17, 2001.

The excise tax was applicable to plan years beginning on or after January 1, 1998 and expired with respect to those benefits for services provided on or after September 30, 2001. The FY2002 appropriation for the Departments of Labor, Health and Human Services, and Education (P.L. 107-116, section 701), enacted on January 10, 2002, retroactively restored the excise tax to September 30, 2001 and effective through December 31, 2002. The excise tax was extended by the Job Creation and Worker Assistance Act of 2002 through December 31, 2003 and by the Working Families Tax Relief Act of 2004 through December 31, 2005.

The Mental Health Parity Reauthorization of 2003, P.L. 108-197, was introduced (S. 1929) and passed in the Senate in November 2003. After being passed in the House on December 8, 2003 the bill was signed into law on December 19, 2003. The legislation extends the mental health parity provisions through 2004 but did not address the extension of the Internal Revenue Code containing the excise tax penalty provision.

H.R. 5970 proposes an extension of the excise tax through December 31, 2007.