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Major Tax Issues in the 110th Congress

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Summary

During the first part of 2007, the most prominent congressional tax-policy action focused on small business. In May, Congress approved legislation (P.L. 110-28) increasing the federal minimum wage and providing small-business tax cuts. The tax cuts were partly designed to ease the adverse effect the minimum-wage increase was argued to have on small businesses.

In the second part of 2007, a major focus of tax legislation was the alternative minimum tax (AMT) for individuals, and how to address its applicability to a growing number of taxpayers. Under current law, individuals pay the higher of their AMT or regular tax. Unlike the regular tax, the AMT is not indexed for inflation, and rising prices, along with income growth and enactment of tax cuts under the regular tax, have increased the AMT's scope. In past years Congress addressed the AMT's growth with temporary measures that restricted its scope, but a short-term cut enacted in 2006 was scheduled to expire beginning with tax year 2007. Proposals to cut the AMT initially included other tax measures — both unrelated tax cuts and revenue-raising provisions designed to offset the impact of tax cuts on the federal budget deficit. As deliberations progressed, however, legislation focused increasingly tightly on the AMT, with a major concern of debate being whether to provide revenue-raising offsets. On December 19, Congress enacted the Tax Increase Prevention Act of 2007 (P.L. 110-166), whose only elements were AMT cuts.

Congress addressed but did not take final action on tax legislation in a variety of other areas over the course of 2007, including energy taxation, tax measures related to the 2007 farm bill, international taxation, and extension of a set of narrowly focused expiring tax benefits (the "extenders"). Where the proposals involved tax cuts, a prominent issue was whether and how to offset the revenue-losing effect of tax cuts. Congress thus considered a range of revenue-raising tax measures over the course of the year — for example, attempting to reduce the "tax gap" between the taxes U.S. taxpayers owe and what they pay, as well as restricting tax shelters and tax benefits for U.S. firms that operate abroad.

A major focus of congressional tax deliberations in early 2008 has been an economic stimulus package, designed to boost what is an apparently flagging economy. Leaders of the House of Representatives reached an agreement with the Administration on a plan containing tax cuts, including a rebate for individual taxpayers and several business tax cuts. On February 7, the House and Senate both approved a modified version of the House stimulus bill, calling for a $151.7 billion tax cut in FY2008.

Other likely areas for congressional action on taxes in 2008 are suggested, in part, by items on which final action was not taken in late 2007: energy taxes, taxes in the farm bill, and the extenders. In addition, leading economic policymakers in Congress and elsewhere have suggested that indications of economic weakness be met with an economic stimulus package that might include a range of tax cuts.

This report will be updated as legislative and economic events occur.

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Major Tax Issues in the 110th Congress

During the first half of 2007, the most prominent congressional action on tax legislation focused on small business. In the first weeks of the new Congress, the House and Senate each approved versions of H.R. 2, a bill increasing the minimum wage. The Senate bill contained small-business tax cuts designed to offset the wage increase's burden for small business, and the House subsequently passed a stand-alone bill (H.R. 976) containing a smaller set of small-business tax benefits. In mid-March, both chambers folded their minimum-wage and respective tax provisions into separate versions of H.R. 1591, a supplemental appropriations bill, and in late April, Congress approved a conference committee version of the bill. On May 1, however, President Bush vetoed the measure because of its Iraq-related provisions. On May 24, Congress approved an alternative spending bill (H.R. 2206) that included the tax provisions, and the President signed the bill the following day (P.L. 110-28).

During the summer of 2007, congressional tax-policy deliberations turned to a variety of narrowly targeted policies — for example, energy taxation, agriculture and conservation-related taxation, tax relief related to forgiven mortgage debt, and a tobacco-tax increase serving as a revenue-raising offset for the State Children's Health Insurance Program (SCHIP). In addition, the farm bill approved by the House on July 27 contained a tax proposal designed to restrict the use of bilateral tax treaties by firms resident in third countries while the Senate Finance Committee in early October approved a tax measure containing agriculture-related provisions along with energy and conservation tax incentives.

A broader issue that Congress focused on as the year progressed was the alternative minimum tax (AMT) for individuals. As described in more detail later in this report, absent congressional action, an increasing number of taxpayers are subject to the AMT each year. In previous years Congress had provided temporary cuts in the AMT that staved off increases in the AMT's applicability. However, the most recently enacted relief expired at the end of 2006, which made the issue increasingly pressing as the end of the 2007 tax year approached.

On October 25, Chairman Charles Rangel of the House Ways and Means Committee introduced H.R. 3970, containing AMT relief as well as a variety of both tax increases and tax cuts for businesses and individuals. The bill's AMT provisions were a one-year cut in the AMT followed by outright repeal. Congressional tax-policy debate increasingly focused on the AMT, and as deliberations proceeded, a central part of the debate — and a major difference between House and Senate AMT proposals — became whether AMT relief should be coupled with revenue-raising measures that would offset any adverse impact of the legislation on the deficit.

On October 30, Chairman Rangel introduced H.R. 3996, whose AMT provisions provided a one-year (through 2007) cut in the AMT rather than H.R. 3970's temporary cut and ultimate repeal. In addition to the AMT, however, the initial version of H.R. 3996 proposed to extend for one year a set of other numerous temporary individual and business tax benefits (the "extenders"). The measure also contained a set of revenue-raising provisions that would bring the estimated revenue impact of the bill close to revenue "neutrality" (raising as much tax revenue as it was estimated to lose). The full House passed the bill on November 9. The Senate did not pass the House bill, and instead approved an amended version of H.R. 3996 containing only temporary AMT relief without either offsetting revenue-raising measures or other tax cuts.

On December 12, the House approved H.R. 4351, another temporary AMT bill that would also be revenue-neutral, but that contained fewer unrelated provisions than the initial House version of H.R. 3996. The Senate, however, did not approve the bill, and on December 19, the House approved the Senate-passed "stand-alone" temporary AMT tax cut without offsets, applicable to 2007. The President signed the measure, which became P.L. 110-166.

A major focus of congressional tax deliberations in the opening month of 2008 has been an economic stimulus package, designed to boost what is an apparently flagging economy. Leaders of the House of Representatives reached an agreement with the Administration on a plan containing large tax elements, including a rebate for individual taxpayers and several business tax cuts. The full House passed the measure as H.R. 5140 on January 28. On January 30, the Senate Finance Committee approved its version of a stimulus plan that differed in some respects from the House-passed bill. On February 7, both the House and Senate approved the version of the stimulus plan the House had passed in January, but modified to deny the rebate to illegal immigrants and to extend the credit to social security and veteran's disability recipients. The President signed the bill; it became P.L. 110-185.

Other likely areas for congressional action on taxes in 2008 are suggested, in part, by items on which final action was not taken in late 2007: energy taxes, taxes in the farm bill, and the extenders.

Congress does not consider tax policy in an economic or budgetary vacuum. This report thus provides a broad view of tax policy's context before taking a closer look at the particular tax issues that Congress has either already considered or appears likely to consider in coming months.

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, taxes can affect the distribution of income across income levels (affecting "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 recent, current, 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

Throughout 2006 and the first two quarters of 2007, 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 22 consecutive quarters. Real growth was relatively sluggish during the first quarters of the recovery, but began to pick up momentum in mid-2003. In 2001 (the first full year of the recovery), real gross domestic product (GDP) grew at a 0.8% rate, followed by 1.6% in 2002, 2.5% in 2003, 3.9% in 2004, 3.2% in 2005, and 3.3% in 2006. The growth rate was 2.5% in the last quarter of 2006, then fell to 0.7% in the first quarter of 2007 before rising to 3.8% in the second quarter and 4.9% in the third. In July, 2007, Federal Reserve Chairman Ben Bernanke characterized the economy's performance in 2007 as being "more consistent with sustainable expansion," after registering more rapid growth earlier in the recovery, although he also noted that weakness in the housing market has placed a drag on growth.[1]

As 2007 progressed, however, signs of economic weakness surfaced in a number of areas. One prominent area was housing, where prices stopped rising after years of growth and drops occurred in house sales and residential investment. Second, financial markets came under strain as investor concerns about the credit quality of mortgages (especially "subprime mortgages") had a damping effect on credit flows. Further, banks began reporting large losses resulting from declines in the market value of mortgages and other assets, leading them to become more restrictive in their lending to firms and households. Also, rising oil prices were believed to have a damping effect as their impact percolated through the economy, and the unemployment rate increased to 5.0% in December.[2] The Federal Reserve

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[1] Ben S. Bernanke, testimony before the House Committee on Financial Services, U.S. Congress, July 18, 2007. Posted on the Federal Reserve Board's website, at [http://www.federalreserve.gov/newsevents/testimony/bernanke20070718a.htm]

[2] This view of developments is largely taken from January 17 testimony of Federal Reserve Chairman Ben Bernanke before the House Budget Committee. The testimony is available

(continued...)

Board responded by taking actions to ease monetary policy in the second part of 2007.

The apparent worsening of the economic situation has led to support for economic stimulus legislation from the Administration, congressional leaders, and Federal Reserve Board Chairman Ben Bernanke. Both the Administration and tax policymakers in Congress began developing a stimulus package in mid-January.[3] (See "Tax Cuts for Economic Stimulus," below on pages 6-8.)

For further reading, see CRS Report RL30329, *Current Economic Conditions and Selected Forecasts*, by Gail Makinen; and CRS Report RL34244, *Would a Housing Crash Cause a Recession?*, by Marc Labonte.

The Federal Budget

According to the Congressional Budget Office (CBO), the federal budget registered a deficit equal to 1.9% of GDP in FY2006.[4] This marks the second consecutive year the deficit has fallen relative to the size of the economy; the deficit was 2.6% of GDP in FY2005 after reaching a level of 3.6% of GDP in FY2004. The deficit in FY2006 marked the fifth year in a row the budget has registered a deficit after being in surplus for the four-year period FY1998-FY2001. However, CBO's most recent budget report (released in January 2007) also projects a continued gradual decline in the deficit as percentage of GDP, with a small budget surplus (0.4% of GDP) occurring in FY2012.[5] 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, 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. The surplus resulted from 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. The difference between the surplus in FY2000 and the deficit for FY2006 was 4.3% of GDP.

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[2] (...continued)
on the Federal Reserve's website, at [http://www.federalreserve.gov/newsevents/testimony/bernanke20080117a.htm], visited January 17, 2008.

[3] Neil Irwin and Jonathan Weisman, "Fed Chairman Backs Stimulus; Bush to Announce 'Principles' Today; Congress Works on Bipartisan Proposal," *The Washington Post*, January 18, 2008, p. A1.

[4] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2007, p. 12.

[5] Ibid., p. 12.

The budget data indicate that the change was a result of both a growth in outlays and a decline in revenues as a percentage of GDP. The decline in revenues was more pronounced, though not by a wide margin. Revenues have declined from 20.9% of GDP in FY2000 to 18.4% in FY2006, a drop of 2.5 percentage points. Outlays have increased by only 1.9 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 FY2006 compared to FY2005 (a decline equal to 0.7% of GDP) resulted from an increase in revenues compared to outlays. Receipts increased by 0.8% of GDP while outlays grew by 0.1% of GDP. The increase in total receipts in FY2006 primarily reflects increases in individual and corporate income tax 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; 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 estimated that extending all tax provisions scheduled to expire between 2007 and 2017 would reduce federal revenue by $3.2 trillion over FY2008-FY2017. This amounts to 9.3% of CBO's projected baseline revenues for the period.[6]

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.[7] According to CBO, either increases in taxes or cuts in spending will be necessary in the future if fiscal stability is to be maintained.[8]

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

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[6] Ibid., p. 101. Baseline revenues are projected to be $34.5 trillion (p. 81).

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

[8] Ibid., p. ix.

1959 — before rising again to 18.4% in FY2006. 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, but while payroll taxes are progressive in the lower and middle parts of the income spectrum, they 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.

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 20.0% in 2004. 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.[9]

For further information, see CRS Report RS20087, *The Level of Taxes in the United States, 1940-2005*, by David L. Brumbaugh; and CRS Report RL32693, *Distribution of the Tax Burden Across Individuals: An Overview*, by Jane G. Gravelle and Maxim Shvedov.

Tax Issues in 2008

Tax Cuts for Economic Stimulus

As noted above (see "The State of the Economy," on page 3), developments in late 2007 have led prominent economic policymakers to call for legislation that would provide an economic stimulus — a package that would possibly include tax cuts. Support for a stimulus package has come from both the Administration and Congress. In addition, in testimony before Congress on January 17, Federal Reserve Board chairman Ben Bernanke stated that legislation providing fiscal stimulus (i.e.,

[9] U.S. Congressional Budget Office, *Historical Effective Federal Tax Rates, 1979 to 2004* (Washington: GPO, 2006). The report is available on the CBO website, at [http://www.cbo.gov/]. The percentage-point declines across quintiles, from lowest to highest, are 1.9, 3.0, 2.7, 3.3, and 2.9. The overall decline is 3.0.

tax cuts or spending increases) would be helpful if implemented quickly and did not compromise "fiscal discipline in the longer term."[10]

On January 24, the Administration and House leaders agreed on the outlines of a stimulus package containing tax cuts that would principally take effect in 2008. On January 29, the House approved H.R. 5140, the Recovery Rebates and Economic Stimulus for the American People Act of 2008, containing the plan developed by the House and the Administration. The stimulus package that began to work its way through the Senate, however, contained significant differences from the House-passed plan.

In broad outline, the House-passed bill contained a tax rebate consisting of a "basic credit" and a per-child tax credit, plus several benefits for business investment. The basic credit was to be the greater of two amounts that depended on a person's tax liability or earned income, respectively — a formulation that would result in a credit of up to $600. The per-child credit would be $300. The bill's business benefits would be an increased "expensing" tax benefit and enhanced ("bonus") depreciation for businesses in 2008. The exact amount of the basic credit would depend on either a taxpayer's pre-credit tax liability or earned income. The credit would be refundable and would be phased out at upper income levels. The revenue loss from the bill was estimated to be $145.9 for FY2008.[11]

The plan approved by the Senate Finance Committee on January 30 likewise provided tax rebates — in this case a $500 basic credit plus (as in the House bill) a $300 child credit. In contrast to the House plan, the Finance Committee proposal would extend the basic credit to a range of Social Security and veteran's disability recipients and would phase out the credit over a higher range of income than the House plan. In contrast to the House bill's expensing benefit and bonus depreciation, the Finance Committee plan proposed to allow businesses to choose among one of three benefits: expensing, bonus depreciation, or an additional "carryback" period for net operating losses. The Finance Committee bill also contained an extension of unemployment benefits that was not in the House bill, as well as a set of extensions of temporary tax benefits related to energy. For FY2008, the total revenue loss and increased unemployment insurance outlays for the Finance Committee bill was estimated at $158.1 billion.[12]

The Final Bill. On February 7 both the House and Senate approved the version of the stimulus plan that the House had passed on January 29, but modified to include the Senate Finance Committee's denial of the rebate to illegal immigrants and its extension of the earned income portion of the credit to Social Security and

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[10] Bernanke testimony, January 17, 2008.

[11] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in H.R. 5140, the "Recovery Rebates and Economic Stimulus for the American People Act of 2008*," JCX-6-08, January 28, 2008.

[12] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the "Economic Stimulus Act of 2008," As Ordered Reported by the Committee on Finance*, JCX-13-08, January 30, 2008.

veterans' disability recipients. The bill is estimated to reduce tax revenue by $151.7 billion in FY2008 and by $134.0 billion over FY2008-FY2013.

To summarize, the final bill's main elements are a tax rebate in the form of a two-part credit, and an increased expensing tax benefit and enhanced depreciation for business investment in 2008.

Tax Rebates. As in the House bill, the final bill's tax rebates are equal to a "basic" tax credit plus a per-child tax credit. The credits will be refundable. Under the basic credit, individuals will receive a tax credit equal to the greater of two amounts that will depend, respectively, on their pre-credit tax liability and their earned income. First, a taxpayer can claim a credit equal to their income tax liability, but not to exceed $600 ($1,200 for a joint return). For the earned income amount, a taxpayer can claim a $300 tax credit ($600 for a joint return) if the individual has at least $3,000 in qualified income (generally, income from salaries and wages, plus Social Security and veterans' disability payments) or an income tax liability of at least $1 and gross income exceeding the sum of the applicable standard deduction and one personal exemption (two, for joint returns). The child tax credit will be $300 for each qualifying child.

The tax credit will ultimately be based on individuals' 2008 tax and income, but it will be issued as checks from the U.S. Treasury during the 2008 calendar year, with the Treasury basing its checks on individuals' 2007 tax returns. When filing their 2008 tax returns (in 2009), individuals will recalculate the credit based on 2008 information, and can claim an additional credit if the 2008 information increases the amount of the credit. If the 2008 credit is less than that actually received, individuals will not be required to pay the difference. According to the Treasury Department, the checks will be issued beginning in May, 2008.[13]

The plan phases out the combined child and basic credit for individuals earning a threshold amount of more than $75,000 ($150,000 for joint returns). It reduces the credit by 5% of the individual's income in excess of the threshold phase-out threshold.

Business Tax Benefits. Under current law, businesses are allowed to "expense" (i.e., deduct immediately) the acquisition cost of a limited amount of new investment in machines and equipment rather than depreciating it over a period of years. Expensing thus provides a postponement (deferral) of taxes which constitutes a tax benefit because of the economic principle of discounting — the idea that a given amount of funds is worth more, the sooner it is received. Prior to the stimulus act, for 2008 firms were permitted to expense up to $128,000 of investment; the allowance was gradually reduced ("phased out") for firms whose investment exceeds a $510,000 threshold. The amount of the allowance was a temporary increase over a permanent cap of $25,000 that is set to apply in 2011 and thereafter. (The permanent phase-out threshold is $200,000.) The stimulus bill provides a one-year

[13] Brett Ferguson, "Congress Passes $152 Billion Stimulus Plan," BNA *Daily Tax Report*, February 8, 2008, p. GG-2.

(for 2008) additional increase in the expensing cap and threshold, to $250,000 and $800,000, respectively.

When not eligible for expensing, outlays for tangible business property — that is, machines and equipment and commercial structures — are required to be deducted gradually over a number of years. For 2008, the stimulus plan provides temporarily more generous depreciation rules for machines and equipment under which 50% of the asset's cost can be deducted in its first year. Like expensing, this provision provides a tax benefit in the form of a deferral, although it is not as large.

Economic Considerations.[14] According to economic theory, the purpose of fiscal stimulus is generally to boost the demand side of the economy in the short run when aggregate demand is thought to be temporarily insufficient to ensure full employment of the economy's resources. In designing a fiscal stimulus, one consideration is therefore whether the chosen approach is effective in injecting funds into the economy. Individuals may save rather spend part of a tax cut or transfers from the government, and different stimulus tools may have different effects on saving. A second consideration is timing. (See, for example, the above statement by Chairman Bernanke.) Stimulus measures address short-term, temporary slackness in aggregate demand, and if a stimulus is mis-timed, it may occur when the economy has resumed positive growth and thus contribute to inflationary pressures. Further, at least part of a fiscal stimulus is spent on imported goods, which means that its impact is partly diluted.

Finally, fiscal stimulus can potentially reduce long-run economic growth. Counter-cyclical fiscal policy works by increasing the federal budget deficit, and herein is a quandary: while a tax cut or spending increase might boost demand in the short run, its effect on the budget deficit can reduce long-term economic growth by reducing the amount of national saving available for investment. Because of these three considerations, a fiscal stimulus package is frequently thought to be effective if it quickly and effectively injects funds into the economy, but does not reduce long-term growth by permanently increasing the federal budget deficit.[15]

Temporary or one-time-only tax cuts or spending increases have sometimes been proposed as a way to provide short-run stimulus without permanently reducing long-run growth. In addition, another specific design question facing policymakers is the appropriate mix of tax cuts and spending tools. From a strictly economic perspective, the answer depends on the particular tax cut or spending increase that is chosen. For example, an increase in government spending can consist of either increased transfers to individuals (for example, increased payments under the various government income-support programs) or an increase of government purchases. Here, an increase in purchases would increase aggregate demand more than either an increase in transfers or a tax cut of identical size because it is likely that at least part

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[14] For a detailed analysis of the stimulus proposal, see CRS Report RL34349, *Economic Stimulus Proposals for 2008: An Analysis*, by Jane G. Gravelle et al.

[15] For a detailed discussion of the economic impact of alternative fiscal policy tools, see CRS Report RS21136, *Government Spending or Tax Reduction: Which Might Add More Stimulus to the Economy?*, by Marc Labonte.

of the latter will be saved rather than spent.[16] A drawback to some types of government purchases, however, is that the government may not be able to put them into place quickly.

Different types of tax cuts are also thought to vary in their effectiveness of injecting funds into the economy. On the business side, for example, investment incentives are generally thought to provide more stimulus per dollar of revenue loss than a cut in corporate tax rates because firms may spend part of the benefit from a rate cut on increases in dividends rather than on investment, and dividend recipients may save rather than spend part of the former. For individuals, there is empirical evidence suggesting that lower-income individuals are more likely to spend more of a tax cut or transfer payment than are higher-income persons. In the case of both business and individual tax cuts, temporary measures would have a less deleterious impact on the budget deficit in the long run.

Congress has enacted tax cuts in the recent past partly to provide a fiscal stimulus. The Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) was enacted partly as a means of boosting an economy that entered recession in March 2001. EGTRRA contained a broad range of tax cuts, but was designed partly to deliver an immediate stimulus, and thus included a rate-reduction tax credit that was mailed to individuals in 2001 as checks from the U.S. Treasury.[17] Following the September 11, 2001, attacks and in the midst of increased certainty that the economy was in recession, Congress considered additional fiscal stimulus proposals that initially included a tax rebate for individuals. The final stimulus package that was adopted (the Job Creation and Worker Assistance Act of 2002; P.L. 107-147), however, did not contain a rebate.[18] The act did include temporary "bonus" accelerated depreciation that was aimed at boosting business investment as well as a temporary extension of net operating loss (NOL) carrybacks for businesses.

Prominent fiscal stimulus measures adopted in past decades were the Revenue Act of 1964 (the "Kennedy" tax cut of 1964; P.L. 88-272) and the Tax Reduction Act of 1975 (P.L. 94-12). The 1964 act reduced both individual and corporate tax rates and augmented the existing investment tax credit for businesses. The 1975 measure included a tax rebate.[19]

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[16] For detailed economic analysis of alternative tax-cut stimulus measures, see CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle, and CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle.

[17] U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress*, committee print, 107th Cong., 2nd sess. (Washington: GPO, 2003), p. 8. For an explanation of the credit, see CRS Report RS21171, *The Rate Reduction Tax Credit — "The Tax Rebate" — in the Economic Growth and Tax Relief Reconciliation Act of 2001: A Brief Explanation*, by Steven Maguire.

[18] For a description of the evolution of the stimulus package, see CRS Issue Brief IB10068, *Major Tax Issues in the 107th Congress*, by David Brumbaugh (archived).

[19] CRS Report 92-20 E, *Tax Cuts and Rebates for Economic Stimulus: The Historical Record*, by Donald W. Kiefer (archived).

H.R. 3970, the Tax Reduction and Reform Act

One of the broadest tax proposals considered by Congress in 2007 was H.R 3970, the Tax Reduction and Reform Act, introduced by Chairman Charles Rangel of the House Ways and Means Committee on October 25. The bill is an omnibus tax package containing a variety of both individual and corporate income tax provisions. "Very preliminary" revenue estimates indicate the bill would reduce revenue by a net total of $53.8 billion over 5 years and by $7.5 billion over 10 years.[20]

On the individual side, a chief focus of the bill is the individual alternative minimum tax (AMT). As described elsewhere in this report, without legislative action, the AMT will include an increasing portion of taxpayers in its scope. The bill has two AMT provisions: (1) a one-year "patch" that does not repeal the tax, but that extends a temporarily higher exemption level and allows nonrefundable regular-tax credits to offset the AMT; and (2) complete repeal of the individual AMT after 2007. (As described below, however, on October 30 Chairman Rangel introduced H.R. 3996, which contains only the temporary reduction for 2007, along with extension of numerous temporary tax benefits for individuals and businesses.)

Beyond the AMT, however, H.R. 3970 proposes a number of general tax cuts for individuals, including an increased standard deduction, an increased child tax credit, and expansion of the number of taxpayers qualifying for the earned income tax credit. The bill would also extend for one year a set of temporary individual income tax benefits ("extenders"). Among the largest of these is the optional deduction for state and local sales taxes and the deduction for tuition.

In addition to these tax cuts, the bill proposes a number of revenue-raising items applicable to individuals, including a surtax on upper-income individuals (designed to offset the cost of repealing the AMT), restoration of limits on itemized deductions and the personal exemption, and an increase in the floor for itemized deductions. In addition, the bill would tax the "carried interest" income of investment fund managers as ordinary income rather than capital gains. The estimated net effect of the bill's individual income tax cuts and revenue-raisers would be a revenue loss of $45.0 billion over 5 years and $6.4 billion over 10 years.

In broad outline, the proposal's corporate income tax provisions couple a very large tax cut provision — reduction of the highest statutory tax rate to 30.5% from current law's 35% — with a number of narrower (but in some cases, sizeable) revenue-raising items. As with individuals, the bill also proposes a one-year extension of temporary corporate tax benefits, and it also would make permanent a temporarily increased "expensing" benefit applicable to investment in equipment by relatively small businesses. Prominent among the bill's revenue-raising measures is a repeal of the tax deduction for domestic production and a deferral of deductions attributable to tax-deferred foreign-source income. Together, the estimated net

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[20] U.S. Congress, House, Committee on Ways and Means, *Estimated Revenue Effects of Proposals Contained in The Tax Reduction and Reform Act of 2007*, (Washington, October 25, 2007). Published in the BNA *TaxCore* service, October 26, 2007.

revenue impact of the corporate provisions would be to reduce revenue by $8.7 billion over 5 years and by $1.0 billion over 10 years.

Taxes in 2007 Agriculture Legislation

On July 27, 2007, the House passed H.R. 2419, an authorization bill related to agriculture (the 2007 "farm bill").[21] The bill's spending provisions are estimated to increase federal spending on agriculture policy above the level allowed by the FY2008 budget resolution. To comply with House pay-as-you-go budget rules, the bill included $4 billion in revenue-raising provisions, the bulk of which would be produced by a proposal designed to curb the use of tax-treaty benefits by firms not actually resident in the treaty country. On October 4, the Senate Finance Committee approved a bill containing a number of agriculture-related provisions, but also energy and conservation measures along with a revenue-raising proposal designed to curtail tax shelters (codification of the "economic substance" doctrine). On December 14, the Senate passed its own omnibus farm bill as an amended version of H.R. 2419, containing (with some differences) the tax proposals approved by the Finance Committee.

The House bill's treaty provision is designed to curb what is sometimes termed "treaty shopping" — situations where a foreign firm with a U.S. subsidiary routes payments from its U.S. subsidiary through a subsidiary in another country so as to take advantage of tax-treaty benefits. While the United States permits U.S. subsidiaries of foreign companies to deduct interest, royalties, and similar payments made to their foreign parents, it also imposes a "withholding tax" on such payments at a nominal rate of 30%. Like most developed countries, however, the United States is signatory to a network of bilateral tax treaties that, among other provisions, frequently provide for the reciprocal reduction or elimination of withholding taxes. Accordingly, a foreign firm whose home country does not have a treaty that substantially reduces the withholding tax may be able to save U.S. withholding tax by routing interest or royalty payments through a subsidiary firm chartered in a country that does have a U.S. treaty that reduces taxes. H.R. 2419's proposal would apply where a foreign-owned U.S. subsidiary makes payments to a foreign subsidiary with a parent in another foreign country, and the withholding-tax rate would be higher if the payment were made directly to the common foreign parent. In such cases, H.R. 2419 would apply the higher of the two withholding tax rates. The Joint Tax Committee has estimated that the revenue gain from the provision would be $3.2 billion over 5 years and $7.5 billion over 10 years.

Supporters of the provision have argued that it will close what they characterize as a "loophole" that permits foreign firms to unfairly avoid U.S. taxes. The provision's opponents have argued that the measure would abrogate U.S. treaties and reduce employment-creating foreign investment in the United States; the administration has threatened to veto the measure.[22] Also, members of the

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[21] For additional information on the farm bill, see CRS Report RL33934, *Farm Bill Legislative Action in the 110th Congress,* coordinated by Renee Johnson.

[22] Brett Ferguson, "House Votes to Repeal Treaty Advantages for U.S. Subsidiaries as Part (continued...)

congressional tax-writing committees have expressed concern about the tax committees' being relied upon to provide budget offsets for other committees.[23]

The bill approved by the Senate Finance Committee on October 4 (the Heartland, Habitat, Harvest, and Horticulture Act) contains a set of tax cuts and increases related to energy, conservation, and agriculture, including both revenue-losing and revenue-raising provisions. Revenue estimates published by the Finance Committee indicate it would be approximately revenue neutral over both 5- and 10-year periods.[24]

Taken alone, the Finance Committee bill's tax cut provisions would reduce revenue by an estimated $12.7 billion over 5 years and $13.8 billion over 10 years. The bill's tax cuts consist of four groups, respectively containing provisions for an agriculture disaster reserve fund, conservation, energy, and agriculture. The bill's revenue raising provisions would together increase revenue by an estimated $13.0 billion over 5 years and $14.3 billion over 10 years. The single largest item is a provision designed to curtail the use of tax shelters: a codification of the judicial "economic substance" doctrine that has developed in court cases related to tax shelters. In general terms, the doctrine denies the use of tax-reducing items — e.g., tax deductions and credits — generated by transactions that do not result in a meaningful change in the taxpayer's economic position.[25] In general, the committee proposal integrates portions of the doctrine into the Internal Revenue Code. The committee's provisions would not apply unless a court determines the economic substance doctrine to be relevant, but when such a determination is made it would apply a two-part ("conjunctive") test to a transaction, requiring that 1) the transaction change the taxpayer's economic position in a meaningful way (an "objective" test); and 2) the taxpayer has a substantial non-federal-tax purpose for engaging in the transaction. In addition, the proposal would apply a 30% penalty for tax understatements where economic substance is lacking.

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[22] (...continued)
of Farm Bill," BNA *Daily Tax Report*, July 30, 2007, p. GG-1.

[23] Brett Ferguson, "Doggett Proposes Closing Loopholes in Treaties to Raise Offset for Farm Measure," BNA *Daily Tax Report*, July 25, 2007, p. G-12. See also Meg Shrive, "Grassed WANS Against Violating Tax Treaties with Farm Bill Tax Provision," *Tax Notes*, August 20, 2007, p. 627.

[24] For the revenue effects of the Finance Committee bill, see U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Chairman's Mark, As Modified, of the "Heartland, Habitat, Harvest and Horticulture Act of 2007,"* Scheduled for Markup by the Committee on Finance on October 4, 2007, JCX-97-07, October 4, 2007.

[25] For a description of the economic substance doctrine as well as the Finance Committee's proposal, see U.S. Congress, Senate, Committee on Finance, *Baucus/Grassed Economic Substance Amendment*, October 4, 2007. Posted on the committee's website, at [http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20100407agamendment.pdf]. For additional information on the economic substance doctrine, see CRS Report RS22586, *The Economic Substance Doctrine: Recent Significant Legal Decisions*, by Erika Lunder.

The tax provisions contained in the farm bill approved by the full Senate in December do not differ substantially from those of the Finance Committee bill.[26]

The Alternative Minimum Tax for Individuals

The individual alternative minimum tax presents a time-sensitive issue for Congress: 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.[27] 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.

The original purpose of the AMT was to ensure that no individual with substantial income could use tax benefits and omissions from the tax base to reduce his or her tax liability below a certain point. There are several 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.

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[26] A description of the full Senate's bill is available on the Finance Committee website, at [http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20121807farmbill.pdf], visited January 8, 2008.

[27] 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.

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 considered to be socially desirable or conducive to economic growth. On the other hand, it is often deemed desirable for a tax system to achieve a certain level of fairness, both in horizontal terms (the equal treatment of individuals with the same income but 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.[28]

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 $569 billion over 10 years, an amount equal to 1.6% 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.[29]

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. In 2004, the Working Families Tax Relief Act (WFTRA; P.L. 108-311) extended through 2005 an exemption amount of $58,000 for married couples and $40,250 for single filers. In 2006 the Tax Increase Prevention and Reconciliation Act (P.L. 109-222) extended the increased exemption for one year. Under TIPRA, the exemption amount is $42,500 (singles) and $62,550 (couples) for 2006. Absent further action, the exemption amounts were scheduled to revert in 2007 to the pre-EGTRRA amounts of $45,000 and $33,750 for couples and singles, respectively.

As enacted in December 2007, H.R. 3996 provides an increased AMT exemption for 2007 of $44,350 (singles) and $66,250 (couples). The act also permits nonrefundable individual income tax credits to offset AMT tax liability for 2007.

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[28] 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.

[29] U.S. Congressional Budget Office, *The Budget and Economic Outlook*, p. 16.

Energy Taxation

Energy taxation was an additional focus of tax legislation in 2007. The focus of proposed legislation was generally two-fold: a revenue-raising scaling-back of tax cuts for petroleum firms that were enacted in recent years; and enactment of a new set of incentives aimed at energy conservation and promotion of alternative energy sources. Those goals were addressed, in part, in an energy bill (H.R. 6) the House passed in January, 2007. The bill restricted several tax benefits as they apply to oil and gas production, and provided that the resulting tax revenues were to be used to fund a reserve for energy efficiency and renewable energy.

In June, the Senate began consideration of its own, amended, version of H.R. 6, which included a wide-ranging non-tax ("policy") component. While the Senate Finance Committee approved a tax package of revenue-raising items and provisions to promote conservation and alternative energy sources, the tax plan was not added to the policy component of H.R. 6 because of opposition to its revenue-raising provisions — especially a tax on oil and gas from the Gulf of Mexico and restrictions on leasing transactions involving foreign property.[30]

In the House, the Ways and Means Committee approved a bill on June 20 restricted to energy tax provisions (H.R. 2776) that, like the earlier Finance Committee measure, contains a mix of revenue raisers and tax benefits. The bill was approved by the House on August 4.

In broad outline, the two committee bills are similar, with their conservation and alternative fuels measures partly offset by revenue-raising items. They differ, however, in the exact make-up of the respective components and in the magnitude of their revenue effects. Specifically, the Finance Committee bill contains revenue-losing items estimated to reduce revenue by a total of $32 billion over 10 years, and revenue-raisers expected to increase revenues by the same amount, thus achieving approximate revenue neutrality on a net basis. The Ways and Means bill is likewise estimated to achieve revenue neutrality, but the expected magnitude of its respective revenue raisers and revenue-losing provisions is smaller, totaling $15 billion over 10 years in each case.

Prominent among the tax benefits in both bills is extension and modification of the tax credit for production of energy from renewable sources provided by Section 45 of the tax code, although the Finance Committee's version would result in a larger revenue loss. The remaining revenue-losing items in the two bills differ considerably.

A large revenue-raising item common to both bills is denial of the tax code's Section 199 domestic production deduction to certain oil- and gas-related income.[31]

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[30] Heather M. Rothman, "Senate Energy Tax Package Could Be Doomed in House," BNA *Daily Tax Report*, June 26, 2007, p. G-1.

[31] Wesley Elmore, "Democrats Outline Early Agenda for 110th Congress," *Tax Notes*, January 8, 2007; Kurt Ritterpusch, "Early Components in Democrats' Oil Industry Rollback (continued...)

The deduction was first enacted with the American Jobs Creation Act of 2004 (P.L. 108-357) and applies to the domestic U.S. manufacturing, extractive, and agriculture industries in general, not just to the petroleum industry. The deduction is phased in, with a rate equal to 6% of domestic production income in 2007-2009, and a permanent rate of 9% in 2010 and thereafter. The Ways and Means bill would deny the deduction to all domestic production of oil and gas; the Finance Committee would deny the deduction to integrated oil companies.

In October, the Finance Committee returned to deliberations on energy tax policy, folding a part of its June energy provisions into a bill containing farm and conservation-related tax provisions. The included energy provisions were the bulk of the earlier measure's tax benefits aimed at domestic fuel security, but not the tax credit for production from renewable sources. A prominent revenue-raising measure was a proposed codification of the economic substance doctrine aimed at restricting tax shelters.

For a more detailed overview of energy tax policy, see CRS Report RL33578, *Energy Tax Policy: History and Current Issues*, by Salvatore Lazzari; and CRS Report RL33763, *Oil and Gas Tax Subsidies: Current Status and Analysis,* by Salvatore Lazzari.

Scheduled Expiration of the 2001 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 for legislation affecting the budget (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"; and
- repeal of the estate tax.

In addition, EGTRRA provided for a temporary reduction in the individual alternative minimum tax (AMT) by increasing the AMT's exemption amount, but scheduled the AMT relief to expire at the end of 2004.

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 of the tax cuts EGTRRA had

[31] (...continued)
Plan Firm Up," BNA *Daily Tax Report*, January 5, 2006.

scheduled to phase-in gradually, generally making them effective in 2003. (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. Also, JGTRRA temporarily implemented a reduction in the maximum tax rate on dividends and capital gains, reducing the rates to 15% (5% for individuals in the 10% and 15% marginal income tax brackets). The reduction was initially scheduled to expire at the end of 2008.

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. WFTRA also extended EGTRRA's increased AMT exemption for one year.

In 2005, TIPRA extended JGTRRA's dividend and capitals gains rate cuts along with its AMT reduction. The dividend and capital gains cuts were extended through 2010; the increased AMT exemption through 2006.

Notwithstanding the various extensions and accelerations, the issue of EGTRRA's scheduled expiration at the end of 2010 remains and was debated in Congress throughout 2006. The debate over extension of the 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.

Tax Administration: The Tax Gap and Tax Shelters

Given congressional interest both in revenue-reducing measures (for example, scaling back the AMT) and concern about the federal budget deficit, it appears likely that policymakers will also focus attention on possible revenue-raising measures that would, in effect, help pay for tax-cuts elsewhere. One possible area is tax administration; in the Senate Finance Committee, leaders from both parties have expressed interest in closing the "tax gap" and in possibly restricting "tax shelters."

The "tax gap" and "tax shelter" concepts are closely related, but not synonymous, so clarification is useful. The tax gap is a concept defined by the

Internal Revenue Service for use in administering the tax code — it is the difference between the amount of tax voluntarily and timely paid by taxpayers and the actual tax liability of taxpayers. The tax gap thus includes both deliberate (and illegal) tax evasion and non-payment that occurs for more innocent reasons: for example, taxpayer error or simple inability to pay. The concept of "tax shelter" is less precisely defined, but is generally an economic concept (though whether to make it a legal one as well is, in fact, an issue that has been debated in congress and elsewhere). A tax shelter is tax-planning device that individual or corporate taxpayers use to either illegally evade or legally avoid taxes in ways that were not intended by policymakers.

The Tax Gap. Leaders of both tax-writing committees have expressed interest in looking for ways to reduce the tax gap. Congressional interest appears to be especially high in the Senate Finance Committee, which conducted hearings on the tax gap in July 2006, and where the gap has been an issue in the confirmation of Eric Solomon to be Assistant Secretary of the Treasury for Tax Policy.[32] In its most recent report on the gap, the IRS estimated its size was $345 billion for tax year 2001 — an amount equal to 16.3% of taxes actually owed and somewhat larger than the $260 billion federal budget deficit projected for FY2006.[33]

As defined by the IRS, the tax gap consists of three components: nonfiling (failure to file a return), underreporting (understating income or overstating deductions), and underpayment (failure to pay reported taxes owed). Of these, underreporting is by far the largest, comprising 83% of the total gap, with underpayment making up 10% and nonfiling 8%. Among the different tax categories, the largest component of the gap was, by far, the individual income tax, accounting for 71% ($245 billion) of the total, followed by employment taxes (17%, or $59 billion), corporate income tax (9%, or $32 billion), and estate taxes (2%, or $8 billion). Within the individual income tax category, the largest component consisted of underreported business income (55%, or $109 billion).[34]

Proposals to reduce the tax gap have included both changes in the tax law and changes in IRS tax administration. Congress may thus address the issue either through its oversight or legislative functions. Legislatively, the staff of the Joint Committee on Taxation (JCT) has issued two reports outlining numerous legislative approaches for reducing the tax gap.[35] The reports contain proposals aimed at

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[32] Allen Kenney, "Treasury Releases Tax Gap Plan; Solomon Nomination Still in Limbo," *Tax Notes*, October 2, 2006, p. 10. Senator Baucus has stated that closing the tax gap "is a passion of mine" (news release by Senator Baucus dated July 10, 2006; available at the Finance Committee website visited November 29, 2006, at [http://finance.senate.gov/hearings/statements/071306MB.pdf].

[33] U.S. Internal Revenue Service, IRS Updates Tax Gap Estimates, news release IR-2006-28, February 14, 2006. Available (along with a variety of other publications about the tax gap) on the IRS website, at [http://www.irs.gov/newsroom/article/0,,id=158619,00.html].

[34] The figures reported here are from the IRS website, at [http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf], visited November 29, 2006.

[35] The first report was U.S. Congress, Joint Committee on Taxation, *Options to Improve Tax*

(continued...)

restricting tax shelters and closing perceived "loopholes," as well as measures that would address non-compliance by other means, including simplification and/or clarification of tax laws, increased withholding, and increased information reporting. A number of the reports' proposals were included as revenue-raising measures in the Tax Increase Prevention and Reconciliation Act of 2006; it thus appears likely that if additional legislation is considered to address the tax gap, it may include items from the JCT report.

In September 2006, the Department of the Treasury's Office of Tax Policy issued a report outlining a strategy for reducing the tax gap.[36] Although the report was lacking in specifics and contained only preliminary information in some areas, it listed a number of different ways in which the IRS might attempt to reduce the tax gap, including strengthening reporting requirements, making efforts to enhance access to data, enhancing examination and collection authority, revising penalties, issuing addition regulations and guidance for taxpayers, increasing research, improving information technology, and establishing more efficient compliance activities.

The report also, however, argued that a component of reducing the tax gap should be reduction in tax-code complexity, which, in the words of the report, "makes the tax law too difficult for taxpayers to understand and for the IRS to administer." It also stated that "enforcement activities should be combined with a commitment to taxpayer service," and that compliance proposals "should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden."[37]

The Treasury Department's qualifications illustrate what is probably the chief policy issue related to the tax gap — the question of how vigorously to address it. There are few policymakers or tax analysts who object — in principle — to the idea of reducing the tax gap. In broad terms, non-compliance not only reduces federal revenues directly (and can thus be viewed as contributing to the budget deficit), the gap also damages the perceived fairness of the tax system on the part of taxpayers who are compliant. Beyond the agreement in principle, however, there are disagreements over the extent to which concerns about taxpayer rights and the overall level of tax burdens should mitigate efforts to shrink the tax gap.

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[35] (...continued)
Compliance and Reform Tax Expenditures, JCS-02-05, January 27, 2005. Available on the Committee's website, at [http://www.house.gov/jct/pubs05.html]. The second was the Joint Committee's Additional Options to Improve Compliance, August 3, 2006, and is available as a Tax Core feature of BNA's *Daily Tax Report* for October 20, 2006.

[36] U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (Washington, September 26, 2006). The report is available on the Office of Tax Policy's website, at [http://www.treas.gov/offices/tax-policy/] (visited November 30, 2006). The report had been requested by Senator Baucus in February, 2006. See Martin A. Sullivan, "Lessons for Congress on Closing Loopholes," *Tax Notes*, March 6, 2006, p. 1024.

[37] U.S. Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, p. 2.

Tax Shelters. In popular usage, the term "tax shelter" denotes the use of tax deductions or credits from one activity to reduce taxes on another. In economic terms, a tax shelter can be defined as a transaction (for example, a paper investment or sale) that reduces taxes without resulting in a reduced return or increased risk for the participant.[38] But so vague and general is the term in most usages, that it could also be defined simply as a tax saving activity that is viewed as undesirable by the person or agency observing the activity and using the term.

Tax shelters can be either legal (tax "avoidance") or illegal (tax "evasion"). To the extent tax shelters are illegal, they therefore contribute to the tax gap; to the extent that they are legal but unintended uses of the tax law ("loopholes"), they reduce tax revenue beyond the loss caused by the tax gap. Like the tax gap, tax shelters not only reduce tax revenue directly, but raise questions about tax fairness among taxpayers not using shelters. In addition, while some shelters lack economic substance, others involve the actual shifting of economic resources solely for the purpose of saving taxes, and may thus reduce economic efficiency.

Congress has evinced considerable interest in tax shelters in recent years and has enacted some restrictions into law. The American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) contained a number of provisions designed to restrict tax shelters. In part, the act's provisions were directed at specific tax shelters — for example, leasing activities and the acquisition of losses for tax purposes ("built in" losses). In addition, the act included provisions — for example, revised penalties and reporting requirements — designed to restrict sheltering activity in general.[39] In 2006, the Senate version of TIPRA contained a number of tax shelter restrictions, but the provisions were not included in the conference committee bill. Prominent among the provisions was what the bill termed a "clarification" of the economic substance doctrine that has been followed in a number of court decisions related to tax shelters. Generally, the economic substance doctrine disallows tax deductions, credits, or similar benefits in the case of transactions determined not to have economic substance. The Senate version of TIPRA would have integrated aspects of the doctrine into the tax code itself. A similar measure was contained in the Senate version of the AJCA, but was not adopted.

Codification of the economic substance doctrine has been estimated by the Joint Tax Committee to raise significant tax revenue. Given continuing federal budget deficits and the adoption of pay-as-you-go type rules in both chambers of Congress, Congress has continued to consider adopting economic substance-related restrictions on tax shelters as a means of providing revenue offsets for tax cuts elsewhere. In October 2007, for example, the Senate Finance Committee approved economic-substance related provisions as part of a package containing energy, conservation, and agriculture tax benefits. (See the preceding section entitled "Taxes in 2007 Agriculture Legislation.") Codification of the economic substance doctrine is also a

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[38] These definitions are taken from Joseph J. Cordes and Harvey Galper, "Tax Shelter Activity: Lessons from Twenty Years of Evidence," *National Tax Journal*, vol. 38, September, 1985, pp. 305-320.

[39] For a list and description, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals Considered in the 108th Congress*, by Jane G. Gravelle.

revenue raising item in the omnibus tax bill (H.R. 3970) introduced by Chairman Rangel of the House Ways and Means Committee.

International Taxation

There are some indications that Congress may include the tax treatment of U.S. firms' foreign income in any search for additional tax revenue. For example, during the summer of 2006, Democratic leaders included a call to "end tax breaks that reward companies for moving American jobs overseas" in the general policy agenda they outlined in the lead-up to the mid-term elections.

Economic theory is skeptical about whether tax policy towards U.S. multinationals can have a long-term impact on domestic employment, although short-term and localized impacts are certainly possible. Taxes can, however, alter the extent to which firms engage in overseas operations rather than domestic investment. Under current law, a tax benefit known as "deferral" poses an incentive for U.S. firms to invest overseas in countries with relatively low tax rates. In general terms, deferral permits U.S. firms to indefinitely postpone U.S. tax on their foreign income as long as that income is reinvested abroad in foreign subsidiaries. Deferral is generally available for active business operations abroad, but the tax code's Subpart F provisions restrict deferral in the case of income from passive investment. If made, proposals to restrict deferral may consist of expansion in the range of income subject to Subpart F.

In recent years, however, the thrust of legislation has been more in the direction of expanding deferral and cutting taxes for overseas operations than for expanding Subpart F. For example, the American Jobs Creation Act of 2004 cut taxes on overseas operations in several ways, while in 2006, TIPRA restricted Subpart F in the case of banking and related businesses receiving "active financing" income and in the case of the "look through" treatment overseas operations receive from other firms (see also the discussion of TIPRA, below). Further, several analysts have recently argued that attempts to tax overseas operations are either counter-productive or outmoded in the modern integrated world economy. (Traditional economic analysis, however, suggests that overseas investment that is taxed at a lower or higher rate than domestic income impairs economic efficiency.)

Budget "PAYGO" Rules

There is some interest in Congress in adopting budget rules that would place new limits on tax cuts and direct spending outlays that increase the federal budget deficit, and the House took action on such rules in the first week of the 2007 session.[40] Such action, while not directly altering tax policy, has the potential of altering the context in which tax policy is considered and could alter both the size and content of tax legislation.

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[40] Steven T. Dennis, "Democrats' First 100 Hours: Costly AMT Rewrite an Opening Challenge to Anti-Deficit Goals," *CQ Weekly*, November 20, 2006, p. 3107.

According to some observers, "pay-as-you-go" (PAYGO) budget rules (now lapsed) that were enacted in 1990 made an important contribution to the federal budget surpluses that occurred in FY1998-FY2001 after decades of deficits.[41] (The rules were provided by the Budget Enforcement Act: BEA, Title XIII of P.L. 101-508, the Omnibus Budget Reconciliation Act of 1990.) Under the PAYGO rules, if legislation enacted over the course of a session were to result in a net increase in the budget deficit, across-the-board spending cuts (sequestration) by the President would be triggered to offset the increased deficit. The initial rules were temporary, but were extended in 1993 and 1997 before terminating in December 2002.

A procedural rule similar to the statutory PAYGO requirement aimed at restricting budget deficits has continued to apply in the Senate. Under the Senate rule, consideration of tax and direct spending legislation is prohibited if the measure would increase the budget deficit during several specified periods (the first fiscal year, the first five fiscal years, and the following five fiscal years). However, tax cuts and spending increases assumed in the budget resolution are exempt from the requirement.

Proposals have been made to either reinstate the lapsed PAYGO rules that were enforced by sequestration, to remove the exemption for budget policies assumed in the budget resolution from the current Senate PAYGO rule, or to apply a rule similar to the current Senate rule in the House.[42] On January 5, 2007, the House approved H.Res. 6, which — among other provisions — implemented PAYGO rules for the House. Along with spending restrictions, the rules provide that it is not in order to consider tax legislation that would either increase the budget deficit or reduce a budget surplus over specified periods, including the current fiscal year, the first 5 fiscal years, or the first 10 fiscal years. In contrast to the current Senate rule, the House PAYGO rule does not exclude tax cuts assumed in the budget resolution.

For additional information, see CRS Report RL32835, *PAYGO Rules for Budget Enforcement in the House and Senate*, by Robert Keith and Bill Heniff, Jr.

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[41] Rudolph G. Penner, "Can Congress Use Budget Rules to Improve Tax Policy?" *Tax Notes*, October 23, 2006, p. 377.

[42] Former Congressional Budget Office director Rudolph Panner has pointed out that while the sequestration rules were effective, they never required deficit reduction — they only applied to increases in the budget deficit. However, because the alternative minimum tax may gradually increase tax liabilities, PAYGO rules would block AMT relief if it were not accompanied by offsets. In that instance, PAYGO rules would act to actually reduce the budget deficit below what would otherwise occur — an effect that Penner believes would be more painful than occurred in the past under the expired PAYGO rules. Ibid., p. 377.

Recently Enacted Tax Legislation

Taxes in Supplemental Appropriations and Minimum Wage Legislation (P.L. 110-28; the Small Business and Work Opportunity Tax Act of 2007)

Tax treatment of small business is a continuing focus of congressional attention, and the first months of the 110th Congress were no exception; consideration of small-business taxation occurred in conjunction with deliberations on the federal minimum wage. The President and others argued that an increase in the federal minimum wage — an issue debated early in the 110th Congress — should be coupled with consideration of tax cuts for small business. The tax cuts were viewed by their proponents as a means of offsetting the extra burden a higher minimum wage may place on small businesses. The tax cuts were enacted on May 24 as the Small Business and Work Opportunity Tax Act of 2007 — a component of a larger act containing appropriations and an increase in the minimum wage (P.L. 110-28).

The act provided tax cuts amounting to an estimated $7.1 billion over 5 years and $4.8 billion over 10 years. The cuts were partly offset by revenue-raising items amounting to $7.0 billion over 5 years and $4.4 billion over 10 years, for a net revenue gain of $71 million over 5 years and $55 million over 10 years — a net effect near to revenue neutrality.[43] Taken alone, the revenue-losing and revenue-gaining measures in the conference agreement fell between the House and Senate bills, in terms of their size. The Senate version of the bill provided both for larger tax cuts and revenue offsets than did the House bill.

The final act's tax cuts were generally, though not exclusively, targeted at small business. A prominent provision was an extension of the **"expensing" tax benefit for business investment** in machines and equipment — a tax benefit provided by Section 179 of the tax code. The provision is linked to small business because it applies only to firms undertaking less than a certain level of investment. The provision is a tax benefit in that it permits firms to deduct in the first year of service ("expense") a capped amount of investment outlays rather than requiring the outlays to be deducted gradually in the form of depreciation, as is required with most tangible assets. Permanent provisions of the Internal Revenue Code cap the expensing allowance at $25,000 per year and begin a phase-out of the allowance when a firm's investment exceeds $200,000.[44] However, temporary rules initially enacted in 2003 and extended on several occasions increased the annual cap and threshold to $100,000 and $400,000, respectively. The increased amounts are indexed for inflation occurring after 2003; the amounts for 2007 are $112,000 and $450,000. The

[43] Revenue estimates are by the Joint Committee on Taxation, and are taken from: U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of Revenue Provisions Contained in the Conference Agreement for H.R. 1591*, JCX-25-07, April 24, 2007. Available at the committee's website, at [http://www.house.gov/jct/pubs07.html].

[44] The cap is reduced on a dollar-for-dollar basis by each dollar of investment exceeding $200,000. Thus, firms undertaking investment in excess of $225,000 cannot claim the allowance under the permanent rules.

most recent extension was provided by TIPRA in 2006 and extended the increased allowance and threshold through 2009. P.L. 110-28 extended the increased expensing allowance and also increased the allowance to $125,000 and the phase-out threshold to $500,000.

Another temporary tax benefit the act addressed was the **work opportunity tax credit (WOTC)**. In general, WOTC permits employers to claim a tax credit equal to a specified percentage paid in first-year wages to members of certain targeted groups, including families receiving Temporary Assistance for Needy Families (TANF) support, qualified veterans, high-risk youth, and others. Under prior law, WOTC was scheduled to expire at the end of 2007; P.L. 110-28 extended the credit through August 2011 and made several modifications in qualification criteria for the targeted groups.

The act modified the **tax credit employers can claim against social security (FICA) taxes paid for employees who receive tips**. The modification was designed to keep the new, higher minimum wage from having the effect of reducing the credit. Under both the act and prior law, the credit is equal to the employer's FICA tax on tips in excess of those meeting the minimum wage requirement. Arithmetic thus dictates that if the minimum wage is increased and no other changes are made (and tips do not increase), the tax credit will be reduced: an increase in the minimum wage reduces the amount by which tips exceed the minimum wage.

P.L. 110-28 increased the minimum wage to $7.25 from prior law's $5.15 and would thus have reduced the tax credit, absent other changes. However, the act provides that the credit will continue to be calculated based on prior law's minimum wage. The act also provided that both the FICA credit and WOTC can offset a taxpayer's alternative minimum tax.

The act contained two principal revenue-raising provisions. One increased the scope of the **"kiddie tax"** — a provision that taxes children under the age of 18 at their parents' tax rate on unearned income exceeding a certain threshold. The act increased the applicable age by one year (i.e., under age 19), or under 24, if full-time students. The second revenue-raising provision lengthens the **period after which interest and penalties are suspended** for unpaid taxes in cases where the taxpayer has not received a notice from the IRS.

Tax Relief and Health Care Act of 2006 (TRHCA; P.L. 109-432)

Separately from the broad tax cuts enacted under EGTRRA and JGTRRA, the tax code contains numerous tax provisions — almost exclusively tax benefits — that were initially enacted on a temporary basis, with specific expiration dates. The provisions ("extenders") tend to be relatively narrow and are generally designed to promote specific types of activity or investment. They have tended to be grouped and considered together with each other, but separately from the more generally applicable tax cuts enacted under EGTRRA and JGTRRA.

The specific areas of economic activity covered by the extenders vary widely, and each presents its own unique policy issues. At the same time, however, the basic economic issues presented by almost all the extenders are similar. Economic theory holds that the economy functions most efficiently when taxes or other factors do not distort the allocation of resources by favoring one activity over another. Only in unusual cases, where there is a failure of the market to function properly, is economic efficiency held to be improved by introducing tax distortions. The extenders each present the question of whether the particular benefit they provide corrects a market failure. (Absent such a failure, however, the particular benefit may be supported by a belief in the social benefit of the activity that is promoted.)

In 2006, Congress considered the extenders as part of reconciliation legislation, but did not include them in the reconciliation bill that was enacted (The Tax Increase Prevention and Reconciliation Bill of 2005; see the discussion in the next section). However, Congress returned to the extenders in its post-election session. On December 9 the Senate approved an extenders bill (H.R. 6111) that had been passed by the House on December 8. The bill was estimated to reduce tax revenue by $38.1 billion over 5 years and $45.1 billion over 10 years. It was signed into law as the Tax Relief and Health Care Act of 2006 (P.L. 109-432).

The following are the temporary provisions extended by H.R. 6111. The extensions are retroactive, and are generally for two years (through 2007).

- Deduction of tuition
- New markets tax credit
- Deduction of state & local sales taxes
- Research and experimentation tax credit
- Work opportunity and welfare-to-work tax credits (combined)
- Earned income tax credit treatment of combat pay
- Qualified zone academy bonds
- Deduction of teacher expenses
- Expensing of brownfields costs
- DC investment incentives
- Indian employment credit
- Depreciation on Indian reservations
- Leasehold depreciation
- Rum excise cover-over to Puerto Rico and Virgin Islands
- Parity in application of mental health benefits
- Charitable contributions of scientific and computer property
- Medical savings accounts
- Suspended limit on percentage depletion
- Economic development credit for American Samoa
- Gulf Opportunity Zone depreciation
- Authority for undercover operations
- Disclosures of certain tax return information

Tax Increase Prevention and Reconciliation Act (TIPRA; P.L. 109-222)

In terms of its revenue impact and scope, the largest tax bill enacted during 2006 was the Tax Increase Prevention and Reconciliation Act (TIPRA; P.L. 109-222). The final version of the bill was estimated to reduce taxes by $70 billion over 10 years — a reduction whose size was modest compared to a number of other tax bills enacted in 2001, 2003, and 2004.

The chief elements of TIPRA were extension of two temporary provisions contained in earlier tax-cut bills: reduced rates for capital gains and dividends, and an increased AMT exemption. As described above, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the tax rate on both capital gains and dividends to 15% (5% for income in the 15% and 10% regular-income brackets), but scheduled its reductions to expire at the end of 2008. Absent an extension, the capital gains rate would have reverted to prior law's 20% rate (10% for income in the lowest brackets) and dividends would have been subject to the tax rates applicable to regular income, which range from 10% to 35%. TIPRA extended the reduced dividend and capital gains rates for two years, through 2010.

As described above, Congress enacted temporary increases in the AMT exemption in 2001 and 2003 under EGTRRA, and JGTRRA, respectively. In 2004, WFTRA extended through 2005 an exemption amount of $58,000 for married couples and $40,250 for single filers. TIPRA extended the increased exemption for one year. Under its provisions, the exemption amount is $42,500 (singles) and $62,550 (couples) for 2006. Absent further action, the exemption amounts will revert in 2007 to the pre-EGTRRA amounts of $45,000 and $33,750 for couples and singles, respectively.

TIPRA also extended for two years (through 2009) an increased "expensing" allowance for small-business investment in machines and equipment; under TIPRA, the maximum expensing allowance is $100,000. (Absent its extension the allowance would have reverted to $25,000.) In addition, TIPRA extended for two years (through 2008) more generous rules for the "active financing income" of U.S. multinational firms. The act also contained a number of revenue-raising items. Among the most prominent was a scaling-back of the exclusions for foreign earned income and housing (provided by Section 911 of the tax code) and a new requirement for withholding by payments made by state and local government entities to contractors.

The conference agreement on TIPRA differed in important respects from both the House and Senate bills. The House bill, but not the Senate bill, contained the extended capital gains and dividend rates; the Senate bill, but not the House bill, contained extension of the increased AMT exemption. As described above, TIPRA contained both. At the same time, however, both the House and Senate bills contained extension of numerous expiring tax provisions ("extenders") beyond the several measures that were ultimately enacted; the bulk of the extenders were dropped from the conference bill. (For more on the extenders, the section above, on page 7.)

The American Jobs Creation Act of 2004 (H.R. 4520; P.L. 108-357)

Congress passed the American Jobs Creation Act (AJCA) (H.R. 4520; P.L. 108-357) 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 were

- 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.)
- 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.
- 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.

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) (H.R. 1308; P.L. 108-311) 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 for varying lengths of time. 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 5 years and $146.9 billion over 10 years.

WFTRA's provisions

- extended the increased ($1,000) child tax credit through 2009;
- extended tax cuts for married couples through 2008;
- extended the widened 10% tax-rate bracket through 2010;
- extended the increased alternative minimum tax exclusion through 2005;
- 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. (See the above section on the "extenders.")

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 new 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 10 years. The stimulus portion of the proposal 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). Another prominent part of the President's 2003 plan was a proposal to move toward "integration" of the taxation of corporate-source income by cutting taxes on dividends and capital gains. The Administration also proposed to increase the "expensing" allowance for small-business investment in equipment. 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 as well as a set of new tax incentives for charitable giving.

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 as follows:

- 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 bracket 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.

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

The final version of the Job Creation and Worker Assistance Act (P.L. 107-147) was 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 as follows:

- 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.

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

EGTRRA (P.L. 107-16) was the first and largest of the several tax cuts enacted during the Bush Administration. It was signed into law on June 7, 2001, and has been estimated to have reduced revenue by an average of 0.71% of GDP per year over its first four years, and by 3.6% of revenues that would otherwise have been collected. In general, its tax cuts were chiefly in individual income taxes and estate taxes, and the reductions tended to be relatively broad in scope rather than tightly targeted to particular activities or investments. The chief reductions were

- a phased-in reduction in statutory individual income tax rates;
- an increase in the per-child tax credit;
- several tax reductions for married couples;
- phase-out of the estate tax; and
- temporary reduction of the individual alternative minimum tax (AMT).

As discussed elsewhere in this report, to conform to a Senate procedural rule, EGTRRA's tax cuts were scheduled (under the act's own terms) to expire at the end of 2010.