DESCRIPTION OF THE
"JOBS AND GROWTH TAX ACT OF 2003"

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By the
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CONTENTS

Page

INTRODUCTION 1

I. ACCELERATION OF CERTAIN PREVIOUSLY ENACTED TAX REDUCTIONS AND INCREASED EXPENSING FOR SMALL BUSINESSES 2

A. Accelerate Reductions in Individual Income Tax Rates 2

B. Accelerate Marriage Penalty Relief 6
1. Standard deduction marriage penalty relief 6
2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns 7

C. Accelerate the Increase in the Child Tax Credit 10

D. Increase Section 179 Expensing 12

II. ELIMINATE THE DOUBLE TAXATIONOF CORPORATE EARNINGS 13

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "Jobs and Growth Tax Act of 2003." The Senate Committee on Finance has scheduled a markup of this proposal for May 8, 2003.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the "Jobs and Growth Tax Act of 2003"* (JCX-42-03), May 6, 2003.

I. ACCELERATION OF CERTAIN PREVIOUSLY ENACTED TAX REDUCTIONS AND INCREASED EXPENSING FOR SMALL BUSINESSES

A. Accelerate Reductions in Individual Income Tax Rates

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2003, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

Table 1.–Individual Regular Income Tax Rates for 2003

If taxable income is over:	But not over:	Then regular income tax equals:
	Single Individuals	
$0	$6,000	10% of taxable income
$6,000....................................	$28,400	$600, plus 15% of the amount over $6,000
$28,400..................................	$68,800	$3,960.00, plus 27% of the amount over $28,400
$68,800..................................	$143,500	$14,868.00, plus 30% of the amount over $68,800
$143,500................................	$311,950	$37,278.00, plus 35% of the amount over $143,500
Over 311,950..........................		$96,235.50, plus 38.6% of the amount over $311,950
	Head of Households	
$0	$10,000	10% of taxable income
$10,000..................................	$38,050	$1,000, plus 15% of the amount over $10,000
$38,050..................................	$98,250	$5,207.50, plus 27% of the amount over $38,050
$98,250..................................	$159,100	$21,461.50, plus 30% of the amount over $98,250
$159,100................................	$311,950	$39,716.50, plus 35% of the amount over $159,100
Over 311,950..........................		$93,214, plus 38.6% of the amount over $311,950
	Married Individuals Filing Joint Returns	
$0	$12,000	10% of taxable income
$12,000..................................	$47,450	$1,200, plus 15% of the amount over $12,000
$47,450..................................	$114,650	$6,517.50, plus 27% of the amount over $47,450
$114,650................................	$174,700	$24,661.50, plus 30% of the amount over $114,650
$174,700................................	$311,950	$42,676.50, plus 35% of the amount over $174,700
Over 311,950..........................		$90,714, plus 38.6% of the amount over $311,950

<u>Ten-percent regular income tax rate</u>

Under present law, the 10-percent rate applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. Effective beginning in 2008, the $6,000 amount will increase to $7,000 and the $12,000 amount will increase to $14,000.

The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The bracket for single individuals and married individuals filing separately is one-half for joint returns (after adjustment of that bracket for inflation).

Reduction of other regular income tax rates

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") the regular income tax rates were 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent.[2] EGTRRA added the 10 percent regular income tax rate, described above, and retained the 15-percent regular income tax rate. Also, the 15-percent regular income tax bracket was modified to begin at the end of the ten-percent regular income tax bracket. EGTRRA also made other changes to the 15-percent regular income tax bracket.[3]

Also, under EGTRRA, the 28 percent, 31 percent, 36 percent, and 39.6 percent rates are phased down over six years to 25 percent, 28 percent, 33 percent, and 35 percent, effective after June 30, 2001. Accordingly, for taxable years beginning during 2001, the rate reduction comes in the form of a blended tax rate. The taxable income levels for the rates above the 15-percent rate in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 2, below, shows the schedule of regular income tax rate reductions.

Table 2.–Scheduled Regular Income Tax Rate Reductions

Taxable Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001[1]-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 and later[2]	25%	28%	33%	35.0%

[1] Effective July 1, 2001.

[2] The reductions in the regular income tax rates are repealed for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

[2] The regular income tax rates will revert to these percentages for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

[3] See the discussion of the provision regarding marriage penalty relief in the 15-percent regular income tax bracket, below.

Alternative minimum tax

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $24,500 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Description of Proposal

Ten-percent regular income tax rate

The proposal accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket. Specifically, beginning in 2003, the proposal increases the taxable income level for the 10-percent regular income tax rate brackets for single individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

Reduction of other regular income tax rates

The proposal accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, for 2003 and thereafter, the regular income tax rates in excess of 15 percent under the proposal are 25 percent, 28 percent, 33 percent, and 35 percent.

Alternative minimum tax exemption amounts

The proposal increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $57,000, and for unmarried taxpayers to $39,750, for taxable years beginning in 2003, 2004, and 2005.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

B. Accelerate Marriage Penalty Relief

1. Standard deduction marriage penalty relief

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[4] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation.[5] For 2003, the basic standard deduction for married couples filing a joint return is 167 percent of the basic standard deduction for single filers (Alternatively, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns). Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.[6] The increase in the standard deduction for married taxpayers filing a joint return is scheduled to be

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[4] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

[5] For 2003 the basic standard deduction amounts are: (1) $4,750 for unmarried individuals; (2) $7,950 for married individuals filing a joint return; (3) $7,000 for heads of households; and (4) $3,975 for married individuals filing separately.

[6] The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same after the phase in period.

phased-in over five years beginning in 2005 and will be fully phased-in for 2009 and thereafter. Table 3, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

Table 3.–Scheduled Phase-In of Increase of the Basic Standard Deduction for Married Couples Filing Joint Returns

Taxable Year	Standard Deduction for Married Couples Filing Joint Returns as Percentage of Standard Deduction for Unmarried Individual Returns
2005	174
2006	184
2007	187
2008	190
2009 and later[1]	200

[1] The basic standard deduction increases are repealed for taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

Description of Proposal

The proposal accelerates the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective beginning in 2003.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[7] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

15-percent regular income tax rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return is twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 4, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

[7] The rate bracket breakpoint for the 38.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

Table 4.–Scheduled Increase in Size of the 15-Percent Rate Bracket for Married Couples Filing Joint Returns

Taxable year	End Point of 15-Percent Rate Bracket for Married Couples Filing Joint Returns as Percentage of End Point of 15-Percent Rate Bracket for Unmarried Individuals
2005	180
2006	187
2007	193
2008 and thereafter[1]	200

[1] The increases in the 15-percent rate bracket for married couples filing a joint return are repealed for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

Description of Proposal

The proposal accelerates the increase of the size of the 15-percent regular income tax rate bracket for joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns beginning in 2003.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

C. Accelerate the Increase in the Child Tax Credit

Present Law

In general

For 2003, an individual may claim a $600 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter (or descendent of either), or eligible foster child.

The child tax credit is scheduled to increase to $1,000, phased-in over several years.

Table 5, below, shows the scheduled increases of the child tax credit.

Table 5.–Scheduled Increase of the Child Tax Credit

Taxable Year	Credit Amount Per Child
2003-2004	$600
2005-2008	$700
2009	$800
2010 and later[1]	$1,000

[1] The credit reverts to $500 in taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.[8] The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $95,000.

The amount of the tax credit and the phase-out ranges are not adjusted annually for inflation.

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[8] Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)).

Refundability

For 2003, the child credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,500.[9] The percentage is increased to 15 percent for taxable years 2005 and thereafter. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,500 (for 2003). The refundable portion of the child credit does not constitute income and isnot treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Alternative minimum tax liability

The child credit is allowed against the individual's regular income tax and alternative minimum tax.

Description of Proposal

The amount of the child credit is increased to $1,000 for 2003 and thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be made in a similar manner to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket. The increase in refundability to 15 percent of the taxpayer's earned income, scheduled for calendar years 2005 and thereafter, is not accelerated by the proposal.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

[9] The $10,500 amount is indexed for inflation.

D. Increase Section 179 Expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179).[10] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. An election to expense these items generally is made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with the consent of the Commissioner.[11] In general, taxpayers may not elect to expense off-the-shelf computer software.[12]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Description of Proposal

The proposal provides that the maximum dollar amount that may be deducted under section 179 is increased to $75,000 for property placed in service in taxable years beginning in 2003 through 2012. In addition, the $200,000 amount is increased to $325,000 for property placed in service in taxable years beginning in 2003 through 2012. Both of these dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2013. The proposal also includes off-the-shelf computer software placed in service in a taxable year beginning in 2003 through 2012 as qualifying property. With respect to a taxable year beginning after 2002 and before 2013, the proposal permits taxpayers to make or revoke expensing elections on amended returns without the consent of the Commissioner.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002, and before January 1, 2013..

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[10] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400(f)) or an empowerment zone (sec. 1397A).

[11] Section 179(c)(2).

[12] Section 179(d)(1) requires that property be tangible to be eligible for expensing; in general, computer software is intangible property.

II. ELIMINATE THE DOUBLE TAXATION OF CORPORATE EARNINGS

Present Law

Under present law, a corporation pays a tax on its taxable income, generally at the rate of 35 percent.[13] To the extent that a corporation distributes its after-tax earnings and profits as a dividend to an individual shareholder, the recipient includes the amount of the dividend in gross income and pays tax at the shareholder's individual tax rate. The after-tax earnings and profits of a corporation consist of earnings that have been taxed to the corporation and earnings that have not been subject to tax due to exclusions, accelerated deductions and credits. A tax is imposed at capital gain rates on the gain of a shareholder at the time the shareholder sells his or her stock.

Under present law, corporations receiving dividends from domestic corporations generally are allowed a deduction of 70 percent or more of the amount of the dividends received. Certain anti-abuse rules prevent corporations from receiving low-taxed dividends and creating a capital loss.[14] The dividends-received deduction on certain debt-financed portfolio stock is reduced.[15]

Description of Proposal

In general

Under the proposal, the excludable portion of any dividend received by a shareholder is not included in gross income. The excludable portion of any dividend is the portion of the dividend which bears the same ratio to the dividend as the amount of the corporation's excludable dividend amount ("EDA") for a calendar year bears to all dividends paid by the corporation during the calendar year. The EDA, as discussed below, generally measures the corporation's fully taxed income reduced by taxes paid. In addition, shareholders may be allowed to increase the basis in their corporate stock to the extent the EDA exceeds the dividends paid by the corporation during the calendar year. These rules apply to both individual and corporate shareholders.[16]

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[13] Lower rates apply to the first $75,000 of taxable income. The benefits of the lower rates are phased-out.

[14] Secs. 246(c) and 1059.

[15] Sec. 246A.

[16] Certain taxable dividends received by a parent corporation from a subsidiary and taxable dividends received by a small business investment company will continue to receive a 100-percent dividends-received deduction.

Excludable dividend amount

A corporation calculates an EDA that measures the amount of the corporation's income that was fully taxed reduced by taxes paid. The EDA, for any calendar year, includes an amount the numerator of which is the amount of Federal income tax[17] in excess of all nonrefundable credits (other than the foreign tax credit and the minimum tax credit attributable to any minimum tax imposed in a taxable year ending before April 1, 2001) shown on a corporation's income tax return filed during the preceding calendar year ("applicable income tax") and the denominator of which is the highest corporate tax rate (35 percent under present law).[18] An assessment of tax not shown on a return is treated as if it were an amount of tax shown on a return for the calendar year in which the tax is assessed. If a tax is paid after the close of the year that it is shown on a return or otherwise assessed, the tax is taken into account in the year paid. The EDA is decreased by the amount of the Federal income tax taken into account in computing the increase in the EDA. No tax imposed for a taxable year ending before April 1, 2001, is treated as an applicable income tax.[19]

The EDA also includes the amount of dividends received from another corporation in the preceding calendar year that are excluded under this provision or amounts added to the basis of stock in the other corporation in the preceding calendar year (as described below).

To the extent that the EDA for a calendar year exceeds the maximum amount of dividends that can be paid by the corporation in the calendar year (determined by reference to the corporation's earnings and profits), the excess is added to the EDA for the succeeding year. No other carryover of an amount in the EDA is allowed except to the extent provided by regulations.

Retained earnings basis adjustments

If the amount of the EDA for a calendar year exceeds the amount of dividends paid by a corporation during that year, a shareholder is allowed to increase the shareholder's basis in the

[17] For this purpose, the income tax includes the taxes imposed on a corporation by sections 11 (corporate income tax), 55 (alternative minimum tax), 511 (unrelated business income tax), 801 (life insurance company income tax), 831 (nonlife insurance company income tax), 882 (income tax on foreign corporations connected with U.S. business), 1201 (alternative capital gain tax), and 1291 (without regard to section 1291(c)(1)(B)) (tax on distributions from a passive foreign investment companies) and 1374 (tax on built-in gains of S corporations). It also includes the accumulated earnings tax and the personal holding company tax prior to their repeal by the proposal.

[18] For this purpose, a timely filed return is treated as filed in the calendar year which includes the date that is the 15th day of the 9th month following the close of the corporation's taxable year.

[19] A corporation whose taxable year ends April 30, 2001, and that files a timely income tax return and pays the tax is treated for purposes of computing an EDA as having filed the return on January 15, 2002 (the date that is the 15th day of the 9th month following the close of the taxable year).

corporation's stock by the portion (if any) of the excess allocated by the corporation to the stock. Basis increases are allocated by a corporation in the same manner as if the corporation actually had made dividend distributions, except that no amount may be allocated to stock described in section 1504(a)(4) (whether or not voting stock) that is limited and preferred as to dividends. The Secretary of the Treasury may prescribe regulations regarding allocations where a corporation has multiple classes of stock. Earnings and profits are adjusted in the same manner as if the allocation were a dividend (i.e., the distributing corporation's earnings and profits are reduced and, if the taxpayer receiving a basis adjustment is a corporation, that corporation's earnings and profits are increased). The allocated basis is added to the shares of stock the taxpayer holds and does not affect the holding periods of the shares.

Cumulative retained earnings basis adjustments account

Each corporation allocating basis adjustments is required to maintain a cumulative retained earnings basis adjustment account ("CREBAA"). The amount in the CREBAA is the cumulative amount of basis allocations for prior calendar years reduced by the amount of distributions in prior calendar years that were treated as described below.

To the extent of the amount in the CREBAA, distributions made by a corporation in a calendar year in excess of the amount in the EDA are not treated as dividends. Instead, the distributions reduce the basis of the shareholder's stock (or result in gain to the extent the distributions exceed the shareholder's basis).[20] These distributions reduce the amount in the CREBAA. The portion of any distribution to which this treatment applies is a fraction (not in excess of one) the numerator of which is the amount in the CREBAA account at the beginning of the calendar year and the denominator of which is the amount of all distributions (other than excluded dividends) paid by the corporation during the calendar year. This treatment is provided separately with respect to each class of stock for which a basis allocation was previously made.

For example, corporation X, a calendar year corporation, has a sole shareholder A. For its first taxable year, X has taxable income of $100, and files a return and pays a tax of $35 in its second taxable year. For all other taxable years in this example, X has no income or loss. On January 1 of its third taxable year, X has an EDA of $65 ($35/.35 less $35). X pays no dividends in the third year but allocates $65 of basis to A, and A increases its basis in the X stock by $65. X has a CREBAA of $65 at the beginning of the fourth year. The value of the X stock declines, and A sells the stock to B for $50 at the beginning of the fourth year. A's gain or loss is computed by taking the $65 into account in determining the basis in the X stock. X then distributes $65 to B later in the fourth year. B treats the $65 as a $50 reduction of the basis in the X stock to zero and a $15 capital gain from the sale of the X stock. X will have no balance in its CREBAA at the beginning of the fifth year.

[20] For purposes of this description, these distributions are referred to as distributions from a CREBAA.

Credits and refunds of overpayments of corporate tax

The overpayment of an applicable income tax (including an overpayment resulting by reason of a carryback) of a corporation is allowed as a credit or refund only to the extent of the applicable income taxes taken into account in computing the corporation's EDA for the calendar year following the calendar year in which the refund or credit is otherwise allowable plus, to the extent the corporation elects, an amount equal to the amount of tax that would produce the amount equal to the EDA for the calendar year in which the refund or credit is otherwise allowable. Thus, for example, assume a corporation has paid no tax in the current calendar year and has an EDA of $65 for the current calendar year. The refund of any overpayment in the year is limited to $35 (the amount of applicable income tax which results in an EDA of $65).

To the extent a credit or refund is made, for purposes of computing EDA, the tax for the calendar year for which the refund or credit is made is reduced (but not below zero) by the amount of the credit or refund, and the excess (if any) reduces the amount in the EDA for the current calendar year, using the formula which converts applicable income tax to an EDA. Thus, in the above example, the EDA for the current calendar year is reduced to zero.

Any overpayment not allowed as a credit or refund by reason of this limitation continues to be an overpayment that will be taken into account in succeeding calendar years, subject to this limitation, until a credit or refund is allowed or made. Interest on an overpayment is not allowed during the period the overpayment is not allowed as a credit or refund by reason of this limitation.

This limitation does not apply to the extent any overpayment is attributable to the foreign tax credit.

Foreign taxes and foreign persons

Treatment of foreign taxes

The foreign tax credit allowable to a domestic corporation does not reduce the amount of the applicable income tax of the corporation. Thus, to the extent the foreign tax credit is allowable, foreign taxes of a domestic corporation are treated as taxes paid for purposes of computing the EDA.

Treatment of distributions from foreign corporations

The EDA of a foreign corporation takes into account only the tax on taxable income effectively connected with the conduct of a U.S trade or business. The EDA is reduced by the amount of any branch profits tax imposed. Also, a foreign corporation's EDA is increased by (i) the excludable portion of any dividend received in excess of any U.S. withholding tax, and (ii) by the amount any distribution from a CREBAA in excess of any U.S. withholding tax.

No foreign tax credit is allowed with respect to the excludable portion of any dividend or from a distribution from a CREBAA.

Taxation of foreign shareholders

In the case of foreign shareholders, both individual and corporate, withholding taxes apply to all dividends and distributions from a CREBAA. Dividends are not treated as excludable and basis adjustments are not made with respect to stock held by foreign persons.

Regulated investment companies (RICs) and Real Estate Investment Trusts (REITs)

Except as provided in regulations, a regulated investment company ("RIC") or real estate investment trust ("REIT") does not have an EDA. Instead special rules allow the treatment of distributions received by, or basis adjustments allocated to, a RIC or REIT to pass through to its shareholders and holders of beneficial interests.

A RIC or REIT that receives excludable dividend income is allowed to designate dividends it makes to its shareholders as excludable dividends to the extent of the amount of excludable dividends it receives. In addition, a RIC or REIT may cause its shareholders to increase their bases in RIC or REIT stock to the extent of any basis increases allocated to stock held by the REIC or REIT. To the extent a RIC or REIT receives distributions from a CREBAA that reduce the basis of stock held by the RIC or REIT, distributions from the RIC or REIT may be treated as distributions from a CREBAA.

A RIC or REIT takes into account excludable dividends received, and distributions from a CREBAA that reduce the basis in stock it holds, in determining its distribution requirements. Excludable dividends and distributions from a CREBAA received by a RIC or REIT are taken into account in applying the gross income tests applicable to RICs and REITs.

If a shareholder or holder of a beneficial interest of a RIC or REIT receives an excludable dividend or is allocated a basis adjustment, any loss on the sale of the RIC or REIT stock held six months or less is disallowed to the extent of the amount of the exclusion or adjustment.

Insurance companies

Under the proposal, all excludable dividends received by a life insurance company are subject to proration. Thus, the excluded dividends are allocated on a pro rata basis between the insurance company's general earnings and those amounts required to pay benefits. The basis increase allocated to an insurance company is treated as an excludable dividend received in the year the adjustment is made, and, as such, is subject to proration. All excludable dividends and basis increases attributable to assets held in a separate account funding variable life insurance and annuity contracts are allocated to the separate account. The policyholder's share of excludable dividends and basis adjustments is includable in the company's income. The company's share of excludable dividends and basis adjustments is added to the shareholder's surplus account of a stock life insurance company.

Excludable dividends and retained earnings basis adjustments of a non-life insurance company are treated in the same manner as taxable dividends in computing the reduction of the deduction for losses.

Partnerships and S corporations

Excluded dividends and basis adjustments received by, or allocated to, partnerships and S corporations

Excludable dividends received by a partnership and basis adjustments to stock held by a partnership pass through to the partners. A partner's adjusted basis in his or her partnership interest is adjusted to reflect excludable dividends and basis adjustments to stock held by a partnership.

Rules similar to the partnership rules apply to S corporations and their shareholders. In the case of S corporations, these amounts also increase the accumulated adjustments account of the corporation.

Distributions made by S corporations

The general provisions, as modified as described below, relating to excludable dividends, retained earnings basis adjustments, and distributions from a CREBAA apply to S corporations and their shareholders. An S corporation takes into account, in computing its EDA, the applicable income taxes imposed for a taxable year the corporation was a C corporation[21], and the tax imposed on built-in gains under section 1374. No amounts are added to an EDA by reason of excludable dividends received by, or basis adjustments allocated to, an S corporation; instead these dividends and basis adjustments flow thru to the shareholders as described above.

The items taken into account in determining the tax imposed on built-in gains under section 1374 no longer will pass through to the shareholders, so that S corporation shareholders generally will not pay a tax on the items which are taxed at the corporate level.[22] The amount of these items (determined without regard to any net operating loss from a C corporation year[23] and reduced by the amount of the tax) increases the corporation's accumulated earnings and profits.

[21] For example, the applicable income taxes imposed shown on a return filed in the final year the corporation was a C corporation or the first year the corporation is an S corporation are taken into account in computing the EDA for years the corporation is an S corporation. Any tax imposed by reason of the LIFO recapture rules of section 1363(d) will be taken into account in computing the corporation's EDA under the usual rules relating to the filing of returns and the payment of tax.

[22] The tax imposed by section 1374 will no longer pass through to shareholders as a loss sustained by the S corporation.

[23] A C corporation loss reduced the earnings and profits (or increased a deficit in earnings and profits) for the taxable year during which the loss arose.

Under regulations, distributions of excludable dividends and amounts from a CREBAA will be treated as made before distributions from the accumulated adjustments account. Thus, under the proposal, distributions by an S corporation with accumulated earnings and profits are made in the following order:

(1) An excludable dividend to the extent of the EDA.

(2) Reduction of basis (or recognition of gain) to the extent of the CREBAA.

(3) Reduction of basis (or recognition of gain) to the extent of the accumulated adjustments account.

(4) Taxable dividend to the extent of accumulated earnings and profits.

(5) Reduction of basis.

(6) Recognition of gain.

Treatment of passive investment income

The tax imposed on S corporation passive income is repealed. The provision terminating an S election as a result of passive income is also repealed.

Trusts and estates

The distributable net income of a trust or estate includes the excludable dividends received by the trust or estate and the distributions from a CREBAA received by the trust or estate.

Cooperatives

The EDA of a cooperative shall be allocated between shares of the corporation held by patrons and shares held by other persons as prescribed by regulations, and no deduction shall be allowed to the cooperative for any excludable dividend or distribution from a CREBAA paid to a patron.

Employee stock ownership plans (ESOPs)

Deductible dividends paid to an employee stock ownership plan ("ESOP") are not treated as dividends for purposes of applying the rules under dividend exclusion rules added by the proposal. Thus, for example, they are disregarded in determining the excludable portion of dividends paid with respect to all dividends made by the corporation. Also, stock on which a deductible dividend may be made is disregarded for purposes of allocating basis adjustments and making distributions from a CREBAA.

Private foundations

Excludable dividends and distributions from a CREBAA will not be included in the calculation of net investment income of a private foundation for purposes of the tax imposed by section 4940.

Anti-abuse rules

If a shareholder does not hold stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (as measured under section 246(c)),[24] the basis of the stock is reduced by the amount of any excludable dividends and allocated basis adjustments. Also, no deduction is allowable with respect to payments related to an excludable dividend or basis increase.

The rules of section 1059 requiring a basis reduction with respect to certain extraordinary dividends are made applicable to the excludable dividends received by, and basis adjustments allocated to, both corporate and noncorporate shareholders. Except as provided by regulations, if an excludable dividend is received, or a basis adjustment is allocated, with respect to a share of stock, the basis reduction applies to that share of stock, without regard to whether the excludable dividend or basis adjustment otherwise would be extraordinary, if received during the first year (or such other period provided by regulations) the taxpayer holds the stock.[25]

In the case of a corporate shareholder, the EDA and the earnings and profits are not increased by any amounts that result in a basis decrease under these rules.

Shareholder indebtedness

In the case of debt-financed portfolio stock held by a corporation, the excludable portion of a dividend is reduced by the average indebtedness percentage (as defined in section 246A) applicable to the stock. Also, there is included in gross income an amount equal to the basis adjustment to any stock held by the taxpayer multiplied by the average indebtedness percentage. The EDA of a corporate shareholder is not increased by any amount included in gross income by reason of this rule.

The investment interest limitations of section 163(d) for individuals apply. In addition, any excludable dividend is not investment income.

Redemptions

The present law rules relating to the treatment of redemptions of stock (either directly by a corporation or through the use of a related corporation) as a dividend or as an exchange remain

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[24] In the case of preferred stock, the periods are doubled.

[25] For this purpose, the holding period of stock acquired from a decedent is determined without regard to the rule otherwise providing for long-term capital gain treatment for the stock (sec. 1223(11)).

the same as under present law. Redemptions treated as exchanges reduce the EDA and CREBAA by the ratable share of the amount attributable to the shares redeemed.

Tax-free reorganizations and liquidations

In the case of a tax-free reorganization or liquidation, the current rules providing for the carryover of tax attributes are amended to provide for the carryover of the acquired corporation's EDA and CREBAA. In the case of a tax-free spin-off, the CREBAA is divided between the distributing and controlled corporations in accordance with regulations provided by the Secretary of the Treasury.

Rights to acquire stock

The Secretary of the Treasury may promulgate regulations treating the holder of a right to acquire stock as the holder of stock and regulations amending the option attribution rules.

Alternative minimum tax

Excluded dividends and reduced gain (or increased loss) resulting from the allocated basis adjustments are not an item of tax preference or adjustment for purposes of determining alternative minimum taxable income (including the determination of adjusted current earnings for corporations).

Accumulated earnings tax and personal holding company tax

The accumulated earnings tax and the personal holding company tax are repealed, for taxable years beginning after December 31, 2002, except that any deficiency dividend or dividend paid on or before the 15th day of the third month after the close of the taxable year which is taken into account in computing the tax for a taxable year beginning before that date may be made. Such a dividend is not treated as a dividend for purposes of applying the dividend exclusion rules of the proposal.

Compliance

Form 1099 will be revised to provide information to shareholders to indicate the amount of excludable dividends and the amount of basis adjustments and the date they are allocated.

A corporation will calculate the EDA and CREBAA and report those amounts to the IRS annually on its income tax return.

Regulations

The Secretary of the Treasury is provided authority to prescribe appropriate regulations to carry out these provisions.

The Secretary of the Treasury may amend the consolidated return regulations (effective as of the effective date of the proposal) to properly account for an EDA of a member of the group, for basis adjustments allocated to a member of the group, and for CREBAA distributions received by a member of the group. These regulations may accelerate the inclusion in the excludable dividend amount with respect to activities of lower-tier members of the group, excludable dividends received from lower-tier members, and increases in basis allocated to stock in lower tier members.

Effective Date

In general

The proposal applies to distributions (and basis adjustments) made after December 31, 2002, with respect to taxes paid for taxable years ending on or after April 1, 2001. Thus, for example, a calendar year corporation that filed its 2001 federal income tax return and paid tax on September 15, 2002, may pay excluded dividends or allocate basis adjustments beginning January 1, 2003, based on the amount of tax paid with respect to its taxable income for 2001.

In 2003, one-third of the applicable income taxes will be taken into account in computing a corporation's EDA; in 2004, two-thirds of the applicable income taxes will be taken into account in computing a corporation's EDA; and in 2005 all of the applicable income taxes will be taken into account in computing a corporation's EDA. The provision will terminate after 2005.

Dividends-received deduction

The present law dividends received deduction continues to apply to distributions (not otherwise treated as excludable dividends) of earnings and profits accumulated in taxable years ending before April 1, 2001, that are distributed before January 1, 2006, with respect to stock issued before February 3, 2003.

Repeal of accumulated earnings tax, personal holding company tax and treatment of passive income of S corporations.

These provisions are repealed for taxable years beginning after December 31, 2004.

S corporation tax on built-in-gains

The provisions relating to the tax on the built-in gains of S corporations (section 1374) are effective for taxes imposed in taxable years beginning after December 31, 2002.[26]

[26] This effective date prevents a change in the taxation of S corporation shareholders for taxable years beginning before January 1, 2003.