
# Major Tax Issues in the 111th Congress

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# Summary

The major focus of congressional tax deliberations in early 2008 had been on an economic stimulus package, designed to boost what was a flagging economy. As the economy continued to be troubled, congressional attention is focused on another stimulus package, which was much larger, and which included spending and tax provisions. While the 2008 economic stimulus included a rebate for individual taxpayers and several business tax cuts estimated to cost $151.7 billion in FY2008, the 2009 economic stimulus package, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5; ARRA) is projected to cost $787 billion over the next few years, with about 40% of the cost reflecting tax cuts. Spending proposals include those on infrastructure, aid to the states, education, and transfer payments such as unemployment compensation and food stamps. Tax provisions include a number of individual income tax provisions targeted at lower and middle income families, including a wage credit, an increase in the earned income tax credit, making the child credit refundable, and education tax provisions. Business provisions included accelerated depreciation, loss carrybacks for small businesses, deferral of tax on the discharge of indebtedness and energy provisions. Provisions liberalizing the treatment of tax exempt bonds are also included.

Likely areas for congressional action in 2009 are suggested, in part, by items on which temporary action in the 110th Congress was taken, such as expiring tax provisions. The President has announced a package of tax proposals costing $2.8 trillion over the next ten years; most of the revenue losses arise from making most of the 2001-2003 tax cuts permanent (with the exception of certain provisions affecting high-income individuals) and extending or making permanent other expiring provisions including the alternative minimum tax (AMT) revision. It also included provisions making permanent some of the middle and lower income tax provisions in the 2009 stimulus package, restricting the benefits of itemized deductions and making a number of revisions in business taxes, which increased revenues.

As Congressional actions continue, the budget resolutions in the House and Senate (H.Con.Res. 85, S.Con.Res. 13) provide for many of the tax proposals included in the Obama Administration budget outline. Specifically, the conference agreement for S.Con.Res. 13, passed by the House and Senate on April 29, 2009, provides for three additional years of AMT relief, without offset, a two-year extension of certain expired and expiring tax provisions, and estate tax reform. The legislation also supports the permanent extension of middle-income tax relief first enacted in 2001 and 2003, including extension of the child tax credit; the 10%, 25%, and 28% tax brackets; and marriage penalty relief. Additional congressional attention may turn to energy tax policy and revenue proposals to help fund health care reform. Corporate tax reform, and the treatment of multi-national corporations, is an active issue as both the Administration and Congress work to address tax havens and other national and international issues.

In the 110th Congress, the most prominent congressional tax-policy action focused on small business. In May 2007, Congress approved legislation (P.L. 110-28) increasing the federal minimum wage and providing small-business tax cuts. Later in that year, a major focus of tax legislation was on temporary measures to restrict the scope of the AMT for individuals. One-year extensions were enacted in 2007 and 2008, and an additional one-year extension was included in ARRA.

This report, which includes contributions from Mindy Levit, will be updated as legislative and economic events occur.

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## Contacts

As the 111th Congress convened, economic stimulus activity through new spending and tax cuts was of primary concern. Proposals that had been mentioned include the extension of bonus depreciation, suspension of rules requiring withdrawals from individual retirement accounts, an employee wage credit, and the suspension of taxes on unemployment benefits. A number of these provisions were enacted in the February 2009 stimulus package, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5). Measures to reduce the budget deficit—such as raising taxes on higher income individuals—may not be introduced in 2009. Instead, it is possible that the reductions of the top tax rates created in 2001 would be allowed to expire at the start of 2011. Legislation was also adopted to increase taxes on tobacco products to finance the Children's Health Insurance Plan (commonly referred to as SCHIP).

Later in the 111th Congress. Policies that may be addressed include the alternative minimum tax, changes in marginal individual income tax rates, estate taxes, corporate income tax rates and revisions, and capital gains rates; and the taxation of small business.

After a discussion of the state of the economy and the environment in which tax policy considerations will occur, this report provides an overview of the issues likely to be debated in the new Congress and key issues addressed in the 110th Congress.

# 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

Recent economic turmoil has already been a source of concern for the 111th Congress. Struggling housing and financial markets may result in the worst recession seen in several decades. Enacting economic and fiscal policies meant to bring a return of stability may be needed into the beginning

of the next decade. Prior to the recent downturns, the economy performed relatively strongly through the first half of 2007, yielding 22 consecutive quarters of real growth.

## Economic Growth

Although real GDP growth was positive in the first half of 2008 after being negative in the last quarter of 2007, it turned slightly negative in the third quarter of 2008 and significantly so in the last quarter, with general recognition that the economy is in a serious recession. This follows a period of relatively strong growth that existed since the last recession ended in November 2001.

Despite 10 months of recession in 2001, real gross domestic product (GDP) grew at a 0.8% rate during that year. This rate was followed by stronger annual growth rates between 2002 and 2004. Though growth was weaker in 2005 and 2006, relative to 2004, the economy continued to perform well as real GDP continued to grow at roughly 3%. Into the first several quarters of 2007, economic growth continued.[1] In July 2007, Federal Reserve Chairman Ben Bernanke characterized the economy's performance 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.[2]

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.[3] The Federal Reserve Board responded by taking actions to ease monetary policy beginning in the second part of 2007. Additional interest rate cuts continued in March, April, and October 2008.

The apparent worsening of the economic situation 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 of 2008 which was enacted in February.[4] (See "Tax Cuts for Economic Stimulus in 2008" below.) As the crisis continued, Congress enacted additional legislation intended to prevent economic conditions from worsening, including the Troubled Asset Relief Program and injections of capital into certain financial and housing related institutions.

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[1] U.S. Department of Commerce, Bureau of Economic Analysis, National Economic Accounts-Gross Domestic Product, available at http://www.bea.gov/national/index.htm#gdp, visited November 24, 2008.

[2] 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.

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

[4] 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.

Though GDP grew in the first two quarters of 2008, with a 2.8% growth rate in the second quarter, it fell sharply in the third quarter, to -0.5%, with an even greater fall in the fourth quarter with negative growth estimated at -6.2%. Preliminary estimates for the first quarter of 2009 estimate a -6.1% rate of growth. At the same time, the unemployment rate rose from 4.9% in January 2008 to 8.5% in March 2009.

For further reading, see CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

## The Federal Budget

According to the Congressional Budget Office (CBO), the federal budget registered a deficit equal of 3.2% of GDP in FY2008. This deficit rose from a FY2007 deficit of 1.2% of GDP.[5] Prior to the increase in FY2008, the deficit had fallen for three consecutive years relative to the size of the economy. The deficit in FY2008 marked the seventh year in a row the budget has registered a deficit after being in surplus for the four-year period FY1998-FY2001.

The budget data indicate that the increase in the deficit 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, although not by a wide margin. Revenues have declined from 20.9% of GDP in FY2000 to 17.7% in FY2008, a drop of 3.2 percentage points. Outlays have increased by 2.5 percentage points over the same period, to 20.9% of GDP in FY2008. The decline in revenues had four main sources: the recession of 2001 and subsequent sluggish economic growth, enacted tax cuts, the economic stimulus payments (tax rebates), and the current economic slowdown.

CBO's most recent budget report (released in September 2008) projects a rise and then a gradual decline in the deficit as percentage of GDP between FY2009 and FY2018, with deficits existing throughout the period.[6] Deficits are projected to rise to 8.3% in FY2009 and then fall to 4.9% in FY2010, reflecting both economic contractions and policy changes. This projection assumes that current policies remain in place, and if that assumption is dropped, the outlook will change. This consideration is important given congressional interest in extending or making permanent some or all of the 2001 and 2003 tax cuts, which are scheduled to expire at the end of calendar year 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 FY2009 and FY2019 would reduce federal revenue by $4.2 trillion over FY2010-FY2019.[7] This increase amounts to 11.8% of CBO's projected baseline revenues of $36 trillion for the period.[8]

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 2007 analysis of the long-term budget outlook projected several

[5] U.S. Congressional Budget Office, *Monthly Budget Review-Fiscal Year 2008*. November 2008, p. 2.

[6] U.S. Congressional Budget Office, http://www.cbo.gov/budget/budproj.shtml, see data tables.

[7] Ibid.

[8] Ibid.

different scenarios for growth of the three programs. Under its "alternative baseline" projection (which reflects likely policy), CBO estimates that spending on the programs will grow the current level of 8.4% of GDP in FY2005 to 14.5% in FY2030 and 18.6% by FY2050.[9] According to CBO, either increases in taxes or cuts in spending will be necessary in the future if fiscal stability is to be maintained.[10]

## 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. In FY2008, receipts equaled 17.7% of GDP.[11] 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 20.5% in 2005. Without more detailed analysis, it is not clear whether the system has become more or less progressive over the entire period; while rates in all quintiles have fallen, the pattern is mixed.[12]

For further information, see CRS Report RL33786, *Individual Tax Rates and Tax Burdens: Changes Since 1960*, by Thomas L. Hungerford; and CRS Report RL32693, *Distribution of the Tax Burden Across Individuals: An Overview*, by Jane G. Gravelle and Maxim Shvedov.

[9] U.S. Congressional Budget Office, *The Long-Term Budget Outlook* (Washington: GPO, 2007), p. 5.

[10] Ibid., p. 2.

[11] Receipts, as a percentage of GDP, were higher in FY2006 (18.5%) and FY2007 (18.8%) than in FY2008.

[12] U.S. Congressional Budget Office, *Historical Effective Federal Tax Rates, 1979 to 2005*, available at http://www.cbo.gov/ftpdocs/88xx/doc8885/12-11-HistoricalTaxRates.pdf. The percentage-point reductions in effective tax rates within the quintiles between 1979 and 2005, from lowest to highest, are 3.7, 4.4, 4.4, 3.8, and 2.0. The overall decline in effective tax rates is 1.7, smaller than the decline in each quintile because the higher income quintiles have a larger share of income.

# Tax Issues and Activity in the 111th Congress

## Economic Stimulus

In response to deteriorating economic conditions, Congress enacted a second stimulus bill in February 2009, the American Recovery and Reinvestment Act of 2009, P.L. 111-5. This package cost $787 billion, and included spending programs, but about 40% of the cost was tax cuts. The elements include the following:

- Temporary income tax cuts for individuals, including $116.2 billion for a 6.2% credit for earnings with a maximum of $400 for singles and $800 for couples, phased out for taxpayers with incomes over $75,000 ($150,000 for joint returns); $4.7 billion for a temporary increase in the earned income credit, $14.8 to increase refundability of the child credit, $13.9 billion to expend tuition tax credits and make them 40% refundable (the refundability feature accounts for $3.9 billion). These provisions are effective for 2009 and 2010, though the associated revenue loss extends over FY2009-FY2011. For 2009 there is also an exclusion for $2,400 of unemployment benefits costing $4.7 billion, a sales tax deduction for new auto purchases at $1.7 billion and an extension of the AMT "patch", mainly a temporary increase in the AMT exemption, at a cost of $70.1 billion. An extension and revision of the first time homebuyers credit has revenue consequences over a longer period, costing $6.6 billion over FY2009-2019. Overall, the individual income tax cuts were $230 billion.
- Tax provisions for business, which lose revenue in FY2009-FY2010 and gain revenue thereafter, including $37.8 billion for extending bonus depreciation, $12.9 billion for the deferral and exclusion of income from the discharge of indebtedness, $4.1 billion for a temporary five year loss carryback for 2008 and 2009 for small business, and $1.1 billion for extending small business expensing. Along with a few other minor provisions, there is a revenue gain from enacting legislation to restrict the carryover of losses with an ownership change, reversing a Treasury ruling from 2007. Because these are largely timing provisions the overall revenue loss for FY2009-FY2010 is $6.2 billion.
- A series of provisions relating to tax exempt bonds aimed at aiding State and local governments, which cost $3.8 billion for FY2009-2010, and $30.0 billion from FY2009-FY2019. Almost half the revenue loss arises from allowing a taxable bond options which would make bonds attractive to tax exempt investors. Other major provisions measured by dollar cost are qualified school construction bonds, recovery zone bonds, and provisions allowing financial institutes more freedom to buy tax exempt bonds.
- A one-year delay in the 3% withholding for government contractors, which costs $5.8 billion in FY2011, gains most of the revenue in the next year, and costs $0.3 billion for FY2009-2019.
- Energy provisions, some permanent and some temporary, totaling $3.4 billion in FY2009-FY2011 and $20.0 billion in FY2009-2019. There is also a provision substituting grants for credits for certain energy projects which shifts benefits to the present.

- The proposal also includes a substitution of grants for the low-income housing credit, which shifts benefits to FY2009 ($3 billion), with a negligible effect over the long term. The plan also includes a much smaller provision to substitute grants for certain energy credits.
- A minor provision ($231 million for FY2009-2019) would provide incentives for hiring unemployed veterans and disconnected youth.

## The Administration's Tax Proposals

President Obama has proposed a series of tax provisions in his budget plan, although some of the details of the plan are not yet available.[13] They include provisions dealing with expiring tax provisions (including the 2001-2003 tax cuts, the AMT "patch", and the extenders (a long-standing group of tax provisions that expire but have been continually extended). They also propose to make some of the stimulus provisions permanent, contain some other individual tax changes, and propose some business tax revisions. (Note that the revenue cost of individual provisions varies, because of interactions, depending on the order in which each provision is estimated; the estimates below report costs reflected in the budget document). Overall, the revenue loss is $2.8 trillion, but most of that loss arises from dealing with the on-going issues of expiring tax provisions.

- Over the period FY2009-FY2019, there is a $2,715.5 billion projected revenue loss from addressing expiring tax provisions. The plan includes a permanent AMT "patch" costing $575.9 billion. The largest cost of the provision is the proposed extension of most of the 2001-2003 tax cuts (including the child credit, marriage penalty provisions, capital gains and dividend provisions, rate reductions, and other provisions). The cost of extending all of the individual tax cuts, plus maintaining the estate tax at its current level is estimated at $2.682.3 billion. This cost is reduced by a $636.7 billion gain from limiting the income tax rate cuts, retaining the top two higher tax rates, phase-out of the personal exemption and itemized deductions, and setting a rate of 20% for capital gains and dividends for those with $200,000 of income ($250,000 for joint returns). The Research and Experimentations tax credit, one of the extenders, would be made permanent at a cost of $74.5 billion, and other extenders would be effective for an additional year.
- Four provisions of the 2009 economic stimulus package would be made permanent: the earnings credit ($536.7 billion), the Earned income credit ($32.8 billion), the child tax credit ($70.4 billion), and the education credit ($74.9 billion), for a total of $714.8 billion.
- Other individual provisions include one additional tax cut, a savers credit ($55 billion). The plan also includes a revenue raiser dedicated to funding health care reform, a provision allowing itemized deductions to offset income at a maximum rate of 28%, raising $317.7 billion. Another small revenue raiser would eliminate

[13] Office of Management and Budget, *A New Era of Responsibility: Renewing America's Promise*, U.S. Government Printing Office, Washington, D.C., posted at http://www.whitehouse.gov/omb/assets/fy2010_new_era/A_New_Era_of_Responsibility2.pdfwww.budget.gov.

the advanced earned income credit, which has been little used (saving $0.9 billion). These provisions have a net gain of $263.6 billion.

- There are two business-related tax cuts, a provision to extend net operating loss carrybacks (costing $18.5 billion) and a provision to exempt capital gains for small businesses (costing $7.1 billion). These provisions lose a total of $25.6 billion.
- Business-related tax provisions raise $352.2 billion in revenue. The largest set of provisions are those for reform of tax rules affecting international income, with the details not specified but raising $210 billion. A provision to repeal the last-in, first out (LIFO) method of inventory accounting would raise $61.2 billion. A series of provisions for oil and gas provisions (including repeal of the production activities deduction, intangible drilling costs expensing, and percentage depletion and imposing an excise tax on Gulf of Mexico Oil), would raise $31.5 billion. Revising carried interest (taxing capital gains of investment managers as earnings, and therefore, ordinary income) would raise $23.9 billion. There is also an increase in superfund excise taxes ($17.2 billion), codification of the economic substance doctrine ($4.9 billion), and requiring information reporting for rental income.

# Provisions for Revenue in the Budget Resolution

After the Obama Administration released the outline of the FY2010 budget, Congress began its consideration of the FY2010 budget in late March 2009. Largely following many of the President's initiatives,[14] the House and Senate agreed to the Budget Resolution Conference Report (S.Con.Res. 13) on April 29, 2009. The conference agreement includes $1.654 trillion in on-budget revenues for 2010, and $10.500 trillion over 2010-2014.

Section 501 of the conference agreement provides for three additional years of AMT relief, without offset, a two-year extension of certain expired and expiring tax provisions, and a new incentive for retirement savings. Also included is expansion of eligibility for the refundable child credit, extension of the child tax credit, extension of the research and experimentation tax credit, the enactment of a tax credit for school construction bonds, and continuation of current estate tax policy. Provision is also made for tax relief that supports working families, such as extending the 10%, 25%, and 28% income tax brackets along with marriage penalty relief and preferential rates for investment income.

Sections 316 and 325 of the resolution specifically provide for deficit-neutral reserve funds for selected tax relief policies. The resolution makes provision for the permanent extension of the deduction for state and local sales taxes, along with the extension of incentives for enhanced charitable giving from individual retirement accounts, including life-income gifts, and enhanced employer-provided child care credit and the dependent care tax credit.

[14] Unless expressly provided, the resolution, according to the conference report, does not assume any of the specific revenue offset proposals provided for in the President's budget. The report states that decisions about specific revenue offsets are made by the House Committee on Ways and Means and the Senate Committee on Finance, which are the tax-writing committees.

The conference report indicates that the cost of enacting such policies may be offset by reforms within the Internal Revenue Code of 1986 that produce higher rates of tax compliance to close the "tax gap" and reduce taxpayer burdens through tax simplification.

# Tax Policy Areas

## 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.[15] The portion will decline for a number of years thereafter if the tax cuts in Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expire occurs as scheduled (after 2010), 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 the Jobs and Growth Tax Relief Reconciliation Act of 2003 (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.

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

[15] 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.

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.[16]

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 the 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.[17]

Congress has addressed the AMT on a temporary basis since 2001 by increasing the exemption amount, thus reducing the number of taxpayers who would otherwise pay the AMT (referred to as the AMT "patch"). Most recently, for tax year 2008, the Tax Extenders and Alternative Minimum Tax Relief Act (Division C of P.L. 110-343) increased the AMT exemption to $46,200 (singles) and $69,950 (couples). The act also extended the allowance of nonrefundable individual income tax credits to offset AMT tax liability. The American Recovery and Reinvestment Act (P.L. 111-5) increased the exemption to $46,700 ($70,950) for 2009. President Obama has proposed to permanently index the AMT exemption at a cost of $575.9 billion from FY2000-FY2010.

## 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;

[16] 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.

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

- 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 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 2008. 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.

During the 2008 presidential campaign, proposals were made to allow the expiration of the highest marginal tax rate and to extend others. To some, this modification would allow for compromise between the need to raise revenue while also improving fairness. Some believe that a compromise might occur with the estate tax (which is scheduled for repeal in 2010): to retain the tax but allow higher exemptions and/or lower rates. As economic stimulus considerations

continue in December 2008, it is likely that the tax cut expirations may not be addressed in 2009, except for the estate tax, as more pressing concerns about the economy take precedence.

President Obama (see above) has proposed to make most of these tax cuts permanent, although the estate tax would be retained at 2009 levels and some provisions affecting high-income taxpayers would not be extended.

## 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." Some provisions, such as credit card reporting, reporting the basis for capital gains, and the economic substance doctrine, have been considered in legislation (as discussed above).

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. Tax shelters often arise from the combination of different tax rules in ways that were not intended by policymakers.

### The Tax Gap

Recent and projected large federal budget deficits have generated congressional and executive branch interest in raising revenue by reducing the tax gap. Other motivations for reducing the tax gap include adverse effects on (1) public trust in the fairness of the tax system, which may adversely affect voluntary compliance with tax laws, and (2) economic efficiency by providing an incentive for inputs of labor and capital to shift to those sectors of the economy with lower taxes.[18]

The IRS defines the *gross* tax gap as "the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay *voluntarily* and timely for that year."[19] And it defines the *net* tax gap as "the amount of the gross tax gap that remains unpaid

[18] For a comprehensive review of the literature on tax compliance, see James Adreoni, Brian Erard, and Jonathan Feinstein, "Tax Compliance," *Journal of Economic Literature*, vol. 36, no. 2, June 1998, pp. 818-860. For an overview of the economics of tax evasion, see Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion," *Journal of Economic Perspectives*, vol. 21, no. 1, winter 2007, pp. 25-48.

[19] Alan Plumley, "Preliminary Update of the Tax Year 2001 Individual Income Tax Underreporting Gap Estimates," Internal Revenue Service, *SOI Tax Stats-Papers-2005 IRS Research Conference*, Washington, June 7-8, 2005, p. 15. Available at http://www.irs.gov/taxstats/productsandpubs/article/0,,id=130103,00.html.

after all enforced and other late payments are made for the tax year."[20] Currently, the measurements of these tax gap concepts exclude illegal activities because the IRS lacks adequate data on these activities.[21]

For tax year 2001, the IRS estimates a gross tax gap of $345 billion, equal to a noncompliance rate of 16.3%.[22] For the same year, IRS enforcement activities, coupled with other late payments, recovered about $55 billion of the gross tax gap, resulting in an estimated net tax gap of $290 billion.[23]

The estimated gross tax gap of $345 billion consists of underreporting of tax liability ($285 billion), nonfiling of tax returns ($27 billion), and underpayment of taxes ($33 billion).[24] For 2001, the $285 billion of underreporting of tax liability had the following components: $197 billion in individual income tax, $54 billion in employment tax, $30 billion in corporate income tax, and $4 billion in estate taxes.[25] There are no estimates of the underreporting of excise taxes.[26] The percentage of individual income tax that was underreported varied significantly depending on the degree of information reporting and whether or not withholding was required. For example, only 1.2% of the sum of wages, salaries, and tips was underreported, but 57.1% of nonfarm proprietor income was underreported. These data suggest that increased information reporting and withholding would reduce the tax gap. The increased revenue would have to be weighed against higher administrative costs of the IRS and higher compliance costs of individuals.

The estimates of the gross tax gap have been heavily publicized. Perhaps as a result, some public officials have emphasized better enforcement of tax laws to raise revenue. According to some, enforcement alone is likely to have a limited impact on the gross tax gap. Acting on this view, the IRS is implementing what it terms a comprehensive approach to reduce the gross tax gap.

Three factors are seen limiting the net revenue potential from increased enforcement. First, much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect. Usually the income is not covered by third-party information returns (e.g., income earned by informal business proprietors who operate on a cash basis). Second, even when the unreported income is detected, some of the resulting tax liability cannot be easily collected, particularly from those taxpayers who are currently unable to pay. Third, many detected tax liabilities are so small relative to enforcement costs that it is not cost effective to pursue collection.

[20] Ibid.

[21] The IRS made tax gap studies for tax years 1979, 1983, and 1987. Each study used a different definition of the tax gap. For a discussion of the changes in the concept of the tax gap, see U.S. General Accounting Office, *Tax Administration: IRS' Tax Gap Studies*, Washington, March 1988, 23 p.

[22] The noncompliance rate is the percentage of the aggregate tax liability that taxpayers do not pay voluntarily and timely for a given year.

[23] U. S. Treasury, Internal Revenue Service, February 2007. Data on the tax gap are available at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf, visited November 26, 2008.

[24] Ibid.

[25] Ibid.

[26] Ibid.

The Office of Tax Policy at the Treasury developed what it considered a comprehensive strategy for reducing the tax gap, guided by the following four key principles:[27]

- Unintentional taxpayer errors and intentional taxpayer evasion should both be addressed.
- Sources of noncompliance should be targeted with specificity.
- Enforcement activities should be combined with a commitment to taxpayer service.
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.[28]

In the 109th and 110th Congresses, numerous bills were introduced concerning the tax gap, and many proposals were made in budgets submitted by the Bush Administration. In the 111th Congress, bills relating to the tax gap may be introduced, and President-Elect Obama included proposals to reduce the tax gap in his budget submissions (the economic substance doctrine, reporting of rental income, and international tax reforms not specified).

## 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.[29] 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 (that is, have no effect on economic activity), 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

[27] U.S. Department of the Treasury, Internal Revenue Service, *Reducing the Federal Tax Gap, Report on Improving Voluntary Compliance*, August 2, 2007, 100 p.

[28] U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap*, pp. 1-2.

[29] 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.

specific tax shelters—for example, leasing activities and the acquisition of losses for tax purposes ("built in" losses).[30]

Clarification of the economic substance doctrine, an issue that has been raised in a number of court decisions is also 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. 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.[31]

## 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 2008 election campaign, Democratic leaders included a call to "end tax breaks that reward companies for moving American jobs overseas." President Obama included in his budget submissions $210 billion of international tax reforms (FY2009-FY2011). While details are not yet available some revision in the deferral rules that allow firms to defer taxes on earnings abroad is indicated.

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

[30] 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.

[31] For more information and analysis of legislative proposals, see CRS Report RS22846, *The Economic Substance Doctrine: Legal Analysis of Proposed Legislation*, by Carol A. Pettit.

## "PAYGO" and Other Budget Enforcement Procedures

The House and Senate establish the general contours of budget policy each year in the form of a concurrent resolution on the budget.[32] Policies reflected in the annual budget resolution regarding total revenues and spending and other aspects of budget policy are enforced through various means, including points of order under the Congressional Budget Act of 1974 and procedural provisions in budget resolutions. In addition, each chamber may establish budget enforcement procedures in its standing rules. These enforcement procedures generally restrict the size and shape of revenue and spending legislation and the timing of legislative action, but may be set aside under certain circumstances.

One of the most important enforcement procedures affecting the development and consideration of revenue legislation is referred to as "Pay-As-You-Go" (PAYGO).[33] In essence, PAYGO requires that legislation reducing revenues or increasing mandatory spending include offsetting revenue increases or mandatory spending decreases so that it is deficit neutral. A statutory PAYGO requirement was established in 1990 but effectively was terminated in late 2002. The House and Senate each have their own PAYGO rules; the House's rule was established in 2007 and the Senate's rule, in effect since 1993, was modified in 2007 in a manner to make it comparable to the House rule. Both rules require deficit neutrality in revenue and direct spending legislation over both five- and ten-fiscal-year periods, as well as the current fiscal year. Each chamber waived their PAYGO rules in the 110th Congress to consider, in particular, legislation dealing with the economic decline. They also waived the rule for the economic stimulus package.

The 111th Congress may consider revenue measures that could entail significant revenue loss, including further modification to the Alternative Minimum Tax and the extension of tax cuts that expire in 2010. The House and Senate may choose to revise PAYGO (by modifying their PAYGO rules, restoring a statutory requirement, or both) or other budget enforcement mechanisms to accommodate the consideration of such measures while promoting fiscal discipline over the long term.

# Prominent Tax Policy in the 110th Congress

## Tax Cuts for Economic Stimulus in 2008

As noted above (see "The State of the Economy"), developments in late 2007 led prominent economic policymakers to call for legislation that would provide an economic stimulus. Support for a stimulus package came from both the Administration and Congress. In addition, in testimony before Congress, Federal Reserve Board chairman Ben Bernanke stated that legislation providing fiscal stimulus (i.e., tax cuts or spending increases) would be helpful if implemented quickly and did not compromise "fiscal discipline in the longer term."[34]

[32] For more detailed information on federal budgeting, see CRS Report 98-721, *Introduction to the Federal Budget Process*, by Robert Keith.

[33] The various PAYGO mechanisms are detailed in CRS Report RL34300, *Pay-As-You-Go Procedures for Budget Enforcement*, by Robert Keith.

[34] Bernanke testimony, January 17, 2008.

On February 7, both the House and Senate approved a version of the stimulus plan that had been passed earlier in the House. The final bill's main elements were 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. The bill is estimated to reduce tax revenue by $151.7 billion in FY2008 and by $134.0 billion over FY2008-FY2013. The smaller revenue loss over the five year period compared to the first year is due to the shifting of tax deductions into the present from depreciation.

The tax rebates were equal to a "basic" tax credit plus a per-child tax credit. The credits were refundable. Under the basic credit, individuals received a tax credit equal to the greater of two amounts that depended, respectively, on their pre-credit tax liability and their earned income. First, a taxpayer could 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 could 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 was $300 for each qualifying child.

The tax credit was ultimately based on individuals' 2008 tax and income, and was issued from the U.S. Treasury during the 2008 calendar year, with the Treasury basing its distributions 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 began to be issued in May, 2008.[35]

The plan phased out the combined child and basic credit for individuals earning a threshold amount of more than $75,000 ($150,000 for joint returns). It reduced 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 $128,000 amount 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 provided a one-year (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 (i.e. depreciated)

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

over a number of years. For 2008, the stimulus plan provided temporarily more generous depreciation rules for machines and equipment under which 50% of the asset's cost could be deducted in its first year. Like expensing, this provision provided a tax benefit in the form of a deferral, although it was not as large.

## Economic Considerations[36]

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 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.[37]

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 of the latter will be saved rather than spent.[38] A drawback to some types of government purchases, however, is that the government may not be able to put them into place quickly.

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[36] For a detailed analysis of the stimulus proposal, see CRS Report RL34349, *Economic Slowdown: Issues and Policies*, coordinated by Jane G. Gravelle et al. For more detail on the specific tax provisions, see CRS Report RS22850, *Tax Provisions of the 2008 Economic Stimulus Package*, coordinated by Jane G. Gravelle.

[37] 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.

[38] 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*, coordinated by Jane G. Gravelle.

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.[39]

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. 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.[40]

## 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 was 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 five years and by $7.5 billion over 10 years.[41]

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[39] 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.

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

[41] 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. For additional discussion of the proposal, see CRS Report RL34249, *The Tax Reduction and Reform Act of 2007: An Overview*, by Jane G. Gravelle.

On the individual side, a chief focus of the bill was 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 had two AMT provisions: (1) a one-year "patch" that did not repeal the tax, but that extended a temporarily higher exemption level and allowed nonrefundable regular-tax credits to offset the AMT; and (2) complete repeal of the individual AMT after 2007. Ultimately, a temporary reduction in the scope of the AMT for 2007 and 2008 was enacted.

Beyond the AMT, however, H.R. 3970 proposed 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 have extended for one year a set of temporary individual income tax benefits ("extenders"). Among the largest of these was the optional deduction for state and local sales taxes and the deduction for tuition. In the fall of 2008, legislation was enacted (the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, P.L. 110-343) to extend the temporary tax benefits through the end of 2009.

In addition to these tax cuts, the bill proposed 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 have taxed 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 was a revenue loss of $45.0 billion over five years and $6.4 billion over 10 years.

In broad outline, the proposal's corporate income tax provisions coupled 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 proposed a one-year extension of temporary corporate tax benefits, and it also would have made permanent a temporarily increased "expensing" benefit applicable to investment in equipment by relatively small businesses. Prominent among the bill's revenue-raising measures was 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 revenue impact of the corporate provisions would have been to reduce revenue by $8.7 billion over five years and by $1.0 billion over 10 years.

## Housing Tax Policy

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343), often characterized as the "rescue bill" enacted in response to financial market crises, included tax provisions. The first one allows the Secretary of the Treasury to apply ordinary gain or loss treatment to certain sales of preferred stock in Fannie Mae or Freddie Mac. The second tax provision denies certain employers whose assets have been purchased under the Troubled Asset Relief Program (TARP) a tax deduction for compensation or other benefits in excess of $500,000 made to their executives or other highly compensated employees and makes tax penalties for excess parachute payments applicable to employers who participate in Troubled Asset Relief Program and their executives.

The Foreclosure Prevention Act of 2008, originally introduced as S. 2636 was largely targeted at the housing sector. It included some regulatory and direct spending provisions; in the latter case, primarily a $4 billion authorization for state and local governments to redevelop abandoned and foreclosed homes. The legislation ultimately became the Housing and Economic Recovery Act of

2008 (H.R. 3221, P.L. 110-289). It also included some tax reductions. In particular, the bill included liberalization of tax exempt mortgage revenue bonds, a tax credit for buyers of homes in foreclosure, a temporary deduction for property taxes by homeowners who do not itemize (capped at $500 for single and $1000 for couples), and an election to refund certain corporate credits in lieu of other business provisions.[42]

Other housing tax legislation in the 110th Congress included the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142) which excludes discharged qualified residential debt from gross income. Qualified indebtedness is defined as debt, limited to $2 million ($1 million if married filing separately), incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence that is secured by such debt. It also includes refinancing of this debt, to the extent that the refinancing does not exceed the principal amount of indebtedness. The provision applied to debt discharges made on or after January 1, 2007 and before January 1, 2010. On October 3, 2008, a provision included in the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the exclusion through the end of 2012.

## Energy Taxation and Extenders

Energy taxation was an additional focus of tax legislation in the 110th Congress. Proposed legislation was generally centered on two areas: 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; P.L. 110-140). 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.

Other energy tax policy was enacted in P.L. 110-343, Division B, the Energy Improvement and Extension Act of 2008. Several temporary energy production incentives were extended, including tax credits for producing electricity from wind and refined coal facilities and for other facilities, including closed and open-loop biomass, solar energy, small irrigation power, landfill gas, trash combustion, and hydropower. Along with an extension of the energy tax credit for solar energy, fuel cell, and microturbine property and for residential energy efficient property, the law allows a new energy tax credit for combined heat and power system property and a 30% investment tax credit rate for advanced coal-based generation technology projects.

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.

Several temporary tax provisions that had expired in 2007 were retroactively extended through 2009 in Division C of P.L. 110-343, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. Often referred to as "extenders," these provisions were originally enacted with expiration dates that have subsequently been extended, in some cases numerous times. The temporary tax provisions include, among others, the tax deduction for state and local sales taxes in lieu of state and local income taxes; the tax deduction for qualified tuition and related expenses; the tax deduction for certain expenses of elementary and secondary school teachers; the

[42] For more information about the new law, see CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, coordinated by N. Eric Weiss.

additional standard tax deduction from gross income for real property taxes; tax-free distributions from individual retirement plans for charitable purposes; the tax credit for increasing research activities; the new markets tax credit; accelerated depreciation for qualified leasehold and restaurant improvements and for certain improvements to retail space; and a few charitable giving provisions.

For a full discussion of the extenders, see CRS Report RL32367, *Certain Temporary Tax Provisions Expiring in 2009 ("Extenders")*, by Pamela J. Jackson and Jennifer Teefy.

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