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Major Tax Issues in the 106th Congress: A Summary

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Major Tax Issues in the 106th Congress: A Summary

SUMMARY

Taxes have been a major focus of congressional attention during the first half of 2000. In part, Congress has returned to many of the issues it addressed last year. In August, 1999, Congress passed a set of tax cuts with the Taxpayer Refund and Relief Act (H.R. 2488; TRRA). However, President Clinton vetoed the bill, arguing that the cuts were too large (an estimated $792 billion over 10 years), would drain funds from Social Security surpluses, and would force reductions in domestic spending. Early in 2000, Congress signaled its intention of revisiting tax cuts with passage on April 13 of a fiscal year (FY) 2001 budget resolution (H.Con.Res. 290) calling for a 5-year tax cut of $175 billion.

By the end of August, Congress had addressed many of the same tax cuts that were in the vetoed 1999 omnibus bill, but in a series of separate bills. The House passed the following bills:

- a tax cut for married couples (initially passed February 10; later included in H.R. 4810);
- H.R. 3081, a tax cut bill linked to other legislation raising the minimum wage (March 9);
- H.R. 4516, repealing the federal tax on telecommunications (September 14);
- H.R. 8, phasing out the estate and gift tax (June 8);
- H.R. 1102, a pension reform bill that includes Individual Retirement Account provisions (July 19; later combined with debt-reduction measures and passed as part of H.R. 5173);
- H.R. 4865, repealing taxes on Social Security benefits (July 27);
- H.R. 4923, providing tax benefits for economically distressed communities.

For its part, the Senate folded tax cuts linked to a minimum wage increase into H.R. 833, a broad bankruptcy bill. On March 2, the Senate approved S. 1134, a bill containing a number of tax benefits for education. On July 14, the Senate approved the House-passed version of H.R. 8, and on July 17 the Senate approved a tax cut for married couples. On September 20, the Senate rejected a conference report on H.R. 4516, containing repeal of a telephone excise tax and IRS, Treasury, and legislative branch appropriations.

On August 5, the President vetoed the marriage-penalty bill, maintaining that it is poorly targeted and too costly. On August 31, the President vetoed H.R. 8, arguing it is fiscally irresponsible and not fair. In its own FY 2001 budget plan, the Administration proposed relatively modest tax cuts targeted at particular areas. The President proposes an estimated $350 billion of gross tax cuts over 10 years, offset by $182 billion of increases in taxes and fees for a net tax cut of $168 billion over 10 years. Prominent parts of the proposal are a tax benefit for retirement saving, expansion of the earned income tax credit, marriage tax penalty relief, child-care tax incentives, a tax credit for long-term care, tax benefits for education, and reduction of the alternative minimum tax for individuals. The largest single tax increase is an increase in tobacco taxes. No action has been taken in Congress on most of the Administration's proposals.

MOST RECENT DEVELOPMENTS

During the first part of 2000, Congress has revisited many of the tax cut measures contained in the Taxpayer Refund and Relief Act of 1999 (H.R. 2488), which Congress approved in August 1999, but which President Clinton vetoed. The tax cuts, however, have been considered in a more incremental way, in separate bills more narrow in scope than H.R. 2488. By mid-July, the House and Senate passed a bill phasing out the estate tax (H.R. 8), and a measure cutting taxes for married couples (H.R. 4810). However, on August 5 the President vetoed H.R. 4810 and on August 31 he vetoed H.R. 8.

BACKGROUND AND ANALYSIS

The General Tax Policy Debate

Taxes in 1999

Taxes were an important part of the public policy debate in Congress during 1999. Much of the debate centered on surpluses in the federal budget and on whether or not to use at least part of the surpluses to finance tax cuts. In 1999, the budget situation was this: there was an overall surplus in the federal budget for FY1999, but the surplus consisted exclusively of surpluses in the off-budget accounts – primarily the surplus in the Social Security accounts. The on-budget accounts remained in deficit in FY1999 but were projected to move into surplus in FY2000. With its FY2000 budget proposal in February, 1999, the Clinton Administration proposed to save the surpluses in the Social Security accounts by using them to pay down the federal debt. At the same time, the President proposed to use the projected on-budget surpluses to finance a modest tax cut – $327 billion over 10 years – and to provide added funding for Medicare, defense spending, and a number of other programs.

Congressional Republicans likewise proposed to use the off-budget surpluses to pay down the federal debt, but proposed using most of the projected on-budget surpluses to finance a larger tax cut. The congressional budget resolution for FY2000 called for a tax cut of $792 billion over 10 years. In August, Congress passed the Taxpayer Refund and Relief Act of 1999 (TRRA; H.R. 2488), which contained the tax cut proposed in the budget resolution. President Clinton vetoed the bill, stating that the tax cut was too large and because of its estimated distributional effects.

The Debate in 2000

In 2000, Congress has revisited many of the tax cuts contained in the TRRA, but with a more incremental approach, passing various parts of the tax cut as stand-alone bills. The most prominent are a phase-out of the estate and gift tax (H.R. 8, passed by the House on June 9 and the Senate on July 14) and a tax cut for married couples (H.R. 4810; a conference report is expected to be considered by the House and Senate on July 20). Other prominent tax cut bills include:

- a tax cut for small businesses linked to a minimum wage increase (H.R. 3810 in the House, passed on March 9; H.R. 833 in the Senate, passed on February 1), containing small business tax cuts linked to a minimum wage;

- a pension reform bill that includes provisions that would increase over 3 years annual contribution limits on Individual Retirement Accounts from

current law's $2,000 to $5,000 (H.R. 1102, passed by the House on July 19; later passed again by the House as part of H.R. 5173);

- a measure repealing of the 3% federal telecommunications tax (H.R. 3916; passed by the House on May 25, approved by the Senate Finance Committee on June 14. Passed again by the House as part of H.R. 4516, which was rejected by the Senate on September 20).

Against this background, both the Administration and the Congressional Budget Office have revised upwards their projections for federal budget surplus expected for both the current fiscal year and the next 10 years. To a large extent, however, the general debate over tax policy remains the same as in 1999: how much of the surplus should be used for federal debt reduction, for spending programs, and for tax cuts? The budget resolution passed by Congress on April 13 (H.Con.Res. 290) calls for a 5-year tax cut of $175 billion. The President's FY2001 budget plan (which has not been adopted) calls for a smaller tax cut of $168 billion over 10 years. Further, the Administration has objected to many of this year's congressional proposals on equity grounds, as well as their cost. The Administration vetoed both the estate tax bill and the tax cut for married couples, arguing that an insufficient share of their benefits would accrue to middle- and lower-income persons.

The Economic Context

Many tax issues may concern an interest in reducing the federal tax burden and the desire to enact tax incentives to promote increased economic growth and savings.

Federal Tax Burden

As a percent of gross domestic product (GDP), federal taxes are at their highest level since the end of World War II: 20.0%, in fiscal year 1999. This is not a dramatic departure from past levels; since the mid 1950s, federal taxes as a percentage of GDP have remained within a range of between 17% and just below 20% of GDP. Growth in the economy combined with federal legislation to reduce the budget deficit (tax increases in 1990 and 1993) have produced a slight increase in federal revenues as a percentage of GDP over the last several years. In FY1990, federal taxes accounted for only 18.0% of GDP. Over the same period, however, the federal budget has improved from a deficit of 3.9% of GDP in FY1990 to a surplus of 1.4% of GDP in FY1999.

While there have been some fluctuations in the distribution of the federal tax burden over the last 20 years, the fluctuations have been concentrated at the ends of the income spectrum. During the 1980s the federal tax burden increased for lower-income families and decreased for upper income families. This trend was reversed in the 1990s with tax reductions at the lower end of the income spectrum and tax increases at the upper end of the income spectrum. Families in the middle income brackets, however, experienced very little change in their federal tax burdens over this period, despite legislated tax cuts. Some of the benefits of the tax changes contained in the 1997 Act will not necessarily accrue to middle-income families. The $500 child tax credit will likely reduce federal taxes for middle income families, but only those families with qualifying children. The benefits of reductions in the tax on capital gains,

expanded IRAs, and other savings and investment incentives will tend to accrue to families at the upper-end of the income spectrum.

For further information, see CRS Report RS20059, *The Federal Tax Burden*, and CRS Report RS20087, *The Level of Taxes in the United States, 1941-1998*.

Economic Performance

Many of the tax proposals being considered in the 106th Congress are intended to boost long-term growth by increasing private saving and investment, thereby expanding the nation's capital stock. It is the impact of these various proposals on saving that is perhaps the most prominent economic performance issue the proposals present. First, can tax incentives for saving or tax benefits for investment actually boost the nation's rate of private saving and investment? Second, total national saving consists of private saving minus government borrowing. Thus, is any expansion the proposals may cause in private saving larger than any increase they also cause in the federal budget deficit (or decrease in the federal budget surplus)? If provisions actually cause an increase in total national saving, the nation's capital stock expands, resulting in higher economic growth. Yet economic analysis is not clear on whether and by how much private savings responds to tax incentives.

A number of the tax provisions that are being considered provide favorable tax treatment to particular types of economic activity, extending special tax credits, deductions, or exclusions to certain activities. In these cases, economic theory suggests that favorable treatment for the specified activities can distort the economy's ordinary decision making and channel more resources into the favored activity than would otherwise occur. Since the economy's resources are limited, this also means that resources are simultaneously drawn away from activities that are not tax-favored. The question that economic analysis pursues is whether a specific intervention in resource allocation actually improves overall economic performance.

An important aspect of any tax proposal is its effect on federal revenues and the federal budget deficit or surplus. Deficit reduction has been a primary focus of budget debates over the past several years. The effects on federal revenue of several elements of the various tax proposals have been questioned. For instance, as noted earlier, economic analysis does not provide clear-cut answers about the extent to which economic activity might increase in response to tax incentives. As a result, the ultimate revenue effects of broad-based tax cuts or tax incentives for saving are unclear. In addition, several changes — notably, those involving IRAs, depreciation, and capital gains — would likely register a much larger revenue impact a number of years in the future rather than in the near term. Thus, revenue estimates confined to these proposals' first few years do not show the potential long-run magnitude of their revenue loss. Their supporters, however, generally argue that the measures would stimulate economic growth that would shrink any revenue loss.

Tax Proposals in 2000

The Death Tax Elimination Act (H.R. 8)

H.R. 8 would phase down, then completely repeal the federal estate and gift tax. The phase-down would gradually reduce the tax rates currently applicable to estates over the period 2001-09. Full repeal would become effective in 2010.

In 2010 the bill would also repeal current law's "step up in basis" available for inherited assets that have appreciated in value over a decedent's lifetime. Under current law, when a person inherits an asset and subsequently sells it, the "basis" of the asset – the amount that can be deducted from the sales price in calculating capital gains under the income tax – is its value at the time of death. With two exceptions, H.R. 8 replaces this step up in basis with a "carryover basis." That is, when an inherited asset is sold, its basis in the hands of the beneficiary is the basis it had in the hands of the decedent. The step up in basis is retained for a decedent's property up to $1.3 million and to property transferred to a spouse up to $3 million.

H.R. 8 was approved by the House on June 9 and by the Senate on July 14. The President vetoed the measure on August 31, arguing that it is fiscally irresponsible and not fair. On September 7, a House vote failed to override the veto. The Joint Committee on Taxation has estimated the 5-year revenue cost of the bill at $28 billion.

For further information, see CRS Report RS20592: *Estate Tax Legislation: A Description of H.R. 8*; and CRS Report RL30600, *Estate and gift taxes: economic issues*.

Tax Cuts for Married Couples (H.R. 4810)

Congress's incremental approach to tax cuts in 2000 began with the Marriage Tax Penalty Relief Act (H.R. 6), a bill whose scope is principally confined to a tax cut for married couples. H.R. 6 was approved by the full House on February 10. The same bill was again passed by the House on July 12 as H.R. 4810, the first of two reconciliation bills required by the FY2001 budget resolution (H.Con.Res. 290)

The House bill takes the same approach to taxes paid by married couples as did the TRRA. The proposal makes four changes: it provides a standard deduction for married couples that is twice that of singles; it increases the beginning and end-points of the earned income tax credit's phaseout range; and it phases in over 6 years a doubling for married couples of the width of the lowest (15%) tax bracket; and it repeals restrictions on refundable personal tax credits under the alternative minimum tax . According to Joint Tax Committee estimates, the proposal would result in a revenue loss of $182.3 billion over 10 years. (By comparison, the total net revenue loss estimated for the TRRA was $792 billion over 10 years; President Clinton's proposal for married couples would reduce revenues by $45 billion.)

On March 30, the Senate Finance Committee approved a bill reducing the marriage penalty that is estimated to reduce revenues by $247.8 billion over 10 years. The bill contains the same basic provisions as H.R. 6, but with two additions. The bill would double the width of the 28% tax bracket for couples, not just the 15% bracket. The bill also would make

permanent the full creditability of nonrefundable credits against the Alternative Minimum Tax (AMT) and provides that refundable credits would not be reduced by the AMT. The bill was approved by the full Senate on July 17 as an amended version of H.R. 4810.

A conference committee version of the bill was approved by the House on July 20 and the Senate on July 21. As with both the House and Senate bills, the conference bill doubles the standard deduction for couples; as in the House bill, it increases the beginning and end points of the Earned Income Tax Credit's phase-out by $2,000. Both provisions would be retroactive to January 1, 2000. As with the House bill, the conference measure doubles the width of the 15% rate bracket for couples, but not that of the 28% bracket. The widening is phased in over the period 2000-04. The bill also permits nonrefundable credits to offset the AMT, and, beginning in 2002, provides that the refundable child credit earned income tax credit are not reduced by the AMT.

On August 5 the President vetoed H.R. 4810, arguing that its revenue cost is too large and that too large a share of the tax cut would accrue to couples currently receiving a marriage tax bonus rather than a marriage tax penalty (BNA *Daily Tax Report*, August 8, 2000, p. G-2).

For further information, see CRS Report RL30419, *The Marriage Tax Penalty: An Overview of the Issues*; CRS Report RL30420, *Marriage Tax Penalties: Legislative Proposals in the 106th Congress.*

Tax Benefits for Education (H.R. 7 and S. 1134)

On March 2, the Senate approved S. 1134, a bill containing a number of tax benefits for education. On March 22, the House Committee on Ways and Means approved H.R. 7. According to news reports, however, consideration of the bill by the full House has been postponed (BNA *Daily Tax Report*, March 31, 2000, p. G-9).

Prominent provisions of both bills are an expansion of education savings account contribution limits to $2,000 from current law's $500, along with extension of qualified withdrawals to include primary and secondary school expenses in addition to current-law's college costs. Both bills would also expand current law's qualified tax-favored tuition programs to include private as well as State institutions and would exclude distributions from gross income. Both the Ways and Means and Senate bills would repeal the 60-month limit on student interest deductions; the Ways and Means bill would increase the related income thresholds for the provision's phase-out. Both bills would provide a new 4-year expenditure schedule for school construction bonds under the tax code's arbitrage rebate rules.

The major difference between the two bills is the presence in the Senate bill of a permanent exclusion from gross income for employer- provided undergraduate and graduate education assistance.

According to Joint Tax Committee estimates, the Senate bill would reduce revenues by $7.7 billion over 5 years and $21.3 billion over 10 years; the Ways and Means bill would reduce revenue by an estimated $3.8 billion over 5 years and $11.6 billion over 10 years.

Taxes and Minimum Wage Legislation (H.R. 3081; S. 625 and H.R. 833)

The full Senate and the House Ways and Means Committee each passed bills on November 9, 1999, that would increase the minimum hourly wage by $1 over 3 years. Both bills also contained tax provisions designed to reduce business taxes along with the increase in the minimum wage. On February 1, 2000, the Senate folded the minimum wage and associated tax provisions of S. 625 into a broad bill relating to bankruptcy, H.R. 833. The Senate subsequently approved the measure.

On March 9, the full House passed a tax cut bill linked with other legislation increasing the minimum wage. The bill is patterned after tax cuts approved in November 1999 by the Ways and Means Committee and that were contained in an earlier version of the minimum wage bill. The tax cuts were initially passed as part of H.R. 3832, but were then combined with House-passed minimum wage legislation as part of H.R. 3081. According to Joint Tax Committee estimates, the tax cuts would reduce revenues by $45.7 billion over 5 years; it contains no revenue raising offsets. Prominent provisions of the bill include:

- a reduction in estate and gift tax rates (the largest tax cut in the bill; see also, however, H.R. 8, which would gradually repeal the estate tax);
- an increase in the expensing tax benefit for small business investment to $30,000, permitting the immediate deduction of amounts that would otherwise be depreciated over a number of years;
- rescission of the repeal of the installment method of accounting that was enacted in 1999 as part of the "extenders" bill (H.R. 1180);
- acceleration of the scheduled phase-in of a 100% deduction for the health insurance costs of self-employed individuals;
- an increase in the portion of business meals that can be deducted; to 60% from current law's 50%;
- an increase in contribution limits for qualified pension plans, with other pension changes; and
- tax benefits directed at economically distressed areas.

The provisions are similar to measures included in the "small business" and "pension" portions of the vetoed Taxpayer Refund and Relief Act of 1999 (H.R. 2488).

The Senate-passed tax provisions associated with its minimum wage bill are quite similar to those of the Ways and Means bill, but with a few differences. The Senate bill contains the same acceleration of the full deductibility of health insurance for the self employed. However, it also provides for a phased-in, above-the-line deduction for health and long-term-care insurance for individuals not covered by employment related plans. The Senate bill would also increase the investment expanding allowance to $30,000 compared to $25,000 under the Ways and Means Committee bill and would allow 80% of business meals and entertainment expenses of small businesses to be deductible. It would make the Work Opportunity Tax Credit permanent. The Senate measure does not contain the estate tax provisions contained in H.R. 3081. When it was initially passed, the Senate bill contained several items that would increase revenues. These items – an increase related to installment sales and one for real estate investment trusts (REITs) – were later enacted with H.R. 1180. According to recent estimates by the Joint Committee on Taxation, the Senate-passed tax provisions of H.R. 833 would reduce revenue by $25.7 billion over 5 years.

According to news reports, procedural issues have delayed consideration of the bill by a conference committee (BNA *Daily Tax Report*, July 13, 2000, p. G-7). The issues are related to the Constitution's requirement that tax bills originate in the House rather than the Senate; the House version of the bankruptcy bill contains no tax provisions.

The Administration has stated its opposition to the manner in which the Congressional bills would implement their $1 increase in the minimum wage; the $1 increase would occur over 3 years, in 3 annual installments. The Administration favors implementing the $1 over 2 years. In addition, the Administration and some Congressional Democrats have voiced opposition to the minimum wage bill's tax cuts, arguing they are risky and favor upper-income individuals. On August 28, 2000, House Speaker Hastert wrote to President Clinton offering to support an increase in the minimum wage over years while dropping the bill's estate tax and pension tax provisions.

Proposals in the President's FY2001 Budget

On February 7, 2000, the Clinton Administration published details of the tax and other budget proposals the President had previously outlined in his state of the Union message. In broad terms, the President proposes gross tax cuts totaling $350 billion over 10 years (according to Administration estimates), partly offset by revenue-raising measures of $182 billion; the proposed net tax cut is thus an estimated $168 billion over 10 years. In substance, the tax proposals are selective, for the most part applying to a variety of narrow areas rather than in an across-the-board fashion. In general, the tax cuts are aimed at particular goals and activities favored by the Administration. Prominent areas proposed for tax relief include: married couples, retirement saving, child care, education, long-term care, and persons covered by the minimum tax. The largest revenue-raising measure is an increase in tobacco taxes. Other revenue-raising items are small, narrow, and varied, and include a variety of measures aimed at what the Administration identifies as "unwarranted" tax benefits and corporate tax shelters. Congress has not taken action on the majority of the President's proposals.

Legislation in 1999

The Taxpayer Refund and Relief Act of 1999 (H.R. 2488)

The FY2000 budget resolution Congress passed in April 1999 called for a tax cut of $792 billion over 10 years. On July 22 the House approved a plan (H.R. 2488) to cut taxes by the $792 billion specified in the budget; the full Senate approved a tax cut bill on July 30. Like the House bill, the Senate plan proposed to cut taxes by $792 billion, but differed in its details. On August 4, a conference committee version of the bill was completed, and both the House and the Senate approved the measure on August 5. However, President Clinton vetoed the bill on September 23.

Like the House and Senate bills before it, the conference version of H.R. 2488 contained a tax cut estimated at $792 billion over its first 10 years. A prominent feature of the conference bill is that a number of its largest provisions -- for example, the rate reductions and marriage penalty relief -- expire ("sunset") after 2008. Also, in a provision taken from the House bill, the conference bill's rate reductions are contingent on federal debt reduction.

The centerpiece of H.R. 2488's tax cuts was an across-the-board reduction in individual tax rates. It provided for each individual income tax rate to be reduced by one percentage point on a phased-in basis. Thus, for example, the 15% rate was reduced to 14% in 2003 and thereafter; the remaining rates were scheduled to be reduced in 2005 and thereafter.

Other prominent provisions of H.R. 2488 included:

- Addressing the marriage tax penalty by making the standard deduction for couples twice that of singles and by increasing the new 14% bracket for couples to twice that of the singles' bracket. The bill also addressed the effect of marriage on the earned income credit by increasing the income range over which the credit is phased out for joint returns.

- An increase in the rate of the dependent care tax credit.

- A phased-in above-the-line deduction for health insurance expenditures and long-term care insurance.

- Expansion of tax-favored education savings accounts, including an increase in the contribution limit and their extension to primary and secondary education expenses.

- Reductions in capital gains tax rates: the bill cut the current 20% and 10% rates to 18% and 8%, respectively. Assets were to be indexed for inflation occurring after 1999.

- Along with other IRA expansions, an increase in allowable annual IRA contribution limits to $5,000 from current law's $2,000.

- Gradual repeal of the individual alternative minimum tax.

- Reduction of the corporate alternative minimum tax by repeal of the 90% limit on foreign tax credits and net operating losses.

- Gradual repeal of the estate and gift tax.

- Permitting U.S.-based multinationals to use so-called "worldwide allocation" of interest expense in calculating their foreign tax credits.

- Extending a number of expiring tax benefits for varying periods of time.

In addition to its tax cuts, the bill contained a small number of revenue-raising provisions. The revenue raisers were generally narrow in scope and small in size. While they were scattered throughout the tax code, they generally would have applied to business and investment income.

A Closer Look at Selected Issues

Marriage Tax Penalties and Bonuses

Defining the married couple as a single tax unit, as does the current federal individual income tax, conflicts with the principle of marriage neutrality. Marriage neutrality means that the tax system should not influence the choice of individuals with regard to their marital status. However, under the current federal income tax system, some married couples pay more income tax than they would as two unmarried singles (a marriage tax penalty) while other married couples pay less income tax than they would as two unmarried singles (a marriage tax bonus). A marriage-neutral income tax is an elusive goal. Marriage neutrality conflicts with two other concepts of equity: progressivity and equal taxation of couples with equal incomes. Regardless of how these three concepts of equity are juggled, an income tax can achieve any two of these goals but cannot simultaneously achieve all three.

A number of bills were introduced in the 106th Congress that tried to mitigate marriage tax penalties. For instance, H.R. 2488, the Taxpayer Refund and Relief Act of 1999, contained a provision that would have increased the standard deduction for a married couple filing a joint return to twice the amount of the standard deduction for a single return, doubled the width of the lowest income tax bracket for married couples, and raised the phase-out range of the Earned Income Tax Credit for married persons. The President vetoed H.R. 2488, but on February 10, 2000, the House approved H.R. 6, which contained the same basic marriage provisions as H.R. 2488. Unlike the vetoed bill, however, the scope of H.R. 6 is confined to a tax cut for married couples. On March 30, the Senate Finance Committee approved S. 2346, a tax reduction for married couples that is somewhat broader than that in H.R. 6.

For further information, see CRS Report RL30419, *The Marriage Tax Penalty: An Overview of the Issues*; CRS Report RL30420, *Marriage Tax Penalties: Legislative Proposals in the 106th Congress*; and, CRS Report RL30485, *The Individual Alternative Minimum Tax: Interaction with Marriage Penalty Relief and Other Tax Cuts.*

The Estate Tax

The estate tax was enacted in 1916 as a revenue source for World War I. As with wealth taxes before it, and like most other taxes, revenue was the primary rationale for the tax. Why the estate tax rather than other possible sources of revenue? There were essentially two reasons: first, the estate tax was viewed as a type of fee for the services by the government in protecting property during lifetime, as well as a fee to cover part of the cost of probating the estate at death. Also, the estate tax was chosen over other taxes for reasons of equity and to reduce the concentration of wealth. In 1997, when the exemption was $600,000, only 3.9% of decedents (90,006 of 2.3 million decedents) left estates large enough to file a tax return. Further, less than half of those required to file a return (42,901, or 1.9% of all estates) owed tax.

The federal estate tax is a tax on wealth and as such, it raises some of the same economic issues as annual wealth taxes, which are economically equivalent to annual capital income taxes. The accumulation of wealth is, in large part, the result of an individual's decision to postpone consumption, to save and accumulate capital during one's life of work and

investment, and to take risks. As such the estate tax is a tax on accumulated savings imposed at the end of one's life. And the tax is paid out of the economy's total supply of private savings — reducing private sector savings and increasing government savings (i.e, tax revenue). But an important economic question is what is the effect, if any, on the lifetime savings behavior of individuals? Does the estate tax reduce savings rates? Does the tax reduce the incentives to accumulate capital? Or do individuals compensate for the tax by increasing their accumulation of pre-tax wealth such that enough after-tax wealth is accumulated to bequeath to their heirs? Such might be the case if individuals derive utility either from the wealth itself, or from their heirs' (children) welfare, or both. However, there is no clear answer to these questions.

The estate tax is part of the overall cost of bequeathing wealth to one's heirs. The existence of the estate tax is believed to reduce the level of planned bequests. If so, reducing the estate tax is likely to increase planned bequests, but according to economic theory, the effect on savings is uncertain. The estate tax does create incentives for lifetime gift giving, for estate planning, for substantial charitable donations, and for the establishment of trusts. With federal marginal estate tax rates ranging as high as 55%, significant resources and time may be expended at minimizing the estate tax burden. And a relatively large estate planning industry — accountants, lawyers, and financial advisors — is available to wealth holders to minimize any potential estate tax burden.

One economic effect — the effect on farms and small businesses — has dominated the recent debate over the estate tax and played a key role in the estate tax cuts enacted as part of the Taxpayer Relief Act of 1997. The estate tax is imposed on business capital and wealth — land, equipment, stock, buildings, etc. — in addition to personal wealth. It is argued that this takes capital out of farms and small businesses, inhibiting their transfer to heirs and retention in the family; that the tax can cause the break-up or dissolution of family farms and small business. A sale of the assets to or merger of the enterprise with a large competitor could reduce market competition and inhibit economic efficiency. These effects were a principal reason for the 1981 estate tax reductions, and have been a key impetus for most of the recent proposals to reduce the estate tax. However, the estate tax is only one of many possible causes for the sale of farm or business assets outside the family at death, and not always the principal cause.

For further information, see CRS Report RS20592: *Estate Tax Legislation: A Description of H.R. 8*; and CRS Report RL30600, *Estate and gift taxes: economic issues*.

The Alternative Minimum Tax for Individuals

To make sure that every person with significant income pays at least a minimum of taxes while still preserving the economic and social incentives in the tax code, Congress created, in 1969, what is now known as the individual alternative minimum tax (AMT). In essence, the AMT is a tax on the use of tax incentives and preferences and was primarily targeted at upper-income taxpayers who were thought to overuse these preferences to reduce or eliminate their regular income tax liabilities. However, since its inception, the value and effectiveness of the minimum tax has routinely been the subject of congressional debate. Recently, many analysts have voiced concern over the expected increase in the number of upper-middle income taxpayers who may be subject to AMT coverage in the near future. This increase will occur because of the combined effects of inflation and recent legislative changes to the regular income tax.

The structural components of the regular income tax are indexed for inflation while the structural components of the AMT are not. Consequently, the gap between tax liabilities under the regular income tax and the AMT will shrink over time and many taxpayers could end up subject to the unindexed AMT or experience reductions in their nonrefundable tax credits under the regular income tax solely as the result of inflation. The potential problems of an indexed regular tax and an unindexed AMT have long been recognized by tax analysts. The Joint Committee on Taxation (JCT) released estimates showing that in 1997, approximately 605,000 taxpayers were subject to the AMT but that the number of taxpayers subject to the AMT will increase to around 9.2 million by tax year 2007. These estimates, however, were made prior to the passage of the Taxpayer Relief Act of 1997. When the effects of both inflation and the 1997 legislative changes are taken into account, preliminary estimates indicate that by 2007, the number of taxpayers falling under either the AMT or AMT limits on their tax credits under the regular income tax will grow to almost 12 million. In general, nonrefundable personal tax credits under the regular income tax are limited to the amount by which a taxpayer's regular income tax liability exceeds his tentative minimum tax. Hence, even if a taxpayer owes no AMT, the AMT could reduce the value of his nonrefundable personal tax credits under the regular income tax.

The child tax credit and the HOPE tax credit are the two changes contained in the 1997 act that would have the largest impact in increasing the number of taxpayers subject to the AMT, either directly or indirectly. Many taxpayers in the upper-middle income ranges likely will see the value of these two credits reduced or eliminated because of the AMT. The prospect that the AMT is now going to affect many upper-middle income taxpayers who were not subject to the tax in the past has prompted some calls in Congress for action to remedy the situation. Congress did take limited action in 1998 by including a provision in the Omnibus Consolidated and Emergency Supplemental Appropriations Act (PL. 105-277) that will mitigate part of the problems with the AMT for tax year 1998. Under this provision, nonrefundable personal tax credits are fully allowed against a taxpayer's regular income tax liability for 1998 even if the credits are in excess of the amount by which the taxpayer's regular income tax exceeds the amount of his tentative minimum tax.

In November, 1999, Congress passed H.R. 1180 which extended (along with other temporary provisions) the full creditability of nonrefundable credits through 2001. As noted above, the President vetoed H.R. 1180. However, on March 30, 2000, the Senate Finance Committee passed a bill (S. 2346) that would make permanent the full creditability of nonrefundable credits against the AMT. The bill would also not reduce refundable credits by the amount of a taxpayer's AMT.

For further information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals* and CRS Report RL30485, *The Individual Alternative Minimum Tax: Interaction with Marriage Penalty Relief and Other Tax Cuts.*

Capital Gains

Since the enactment of the individual income tax in 1913, the appropriate taxation of capital gains income has been a perennial topic of debate in Congress. Capital gains income is often discussed as if it were somehow different from other forms of income. Yet, in economic terms, capital gains income is essentially no different from any other form of income from capital, such as interest or dividend income. A capital gain or loss is the result of a sale or exchange of a capital asset. If the asset is sold for a higher price than its acquisition price,

then the transaction produces a capital gain. If an asset is sold for a lower price than its acquisition price, then the transaction produces a capital loss.

Current law's treatment of capital gains differs from what would occur under a theoretically pure income tax. Ideally, a tax consistent with a theoretically correct measure of income would be assessed on real (inflation-adjusted) income when that income accrues to the taxpayer. Conversely, real losses should be deducted as they accrue to the taxpayer. In addition, economic theory indicates that any real appreciation in the value of capital assets given as gifts or bequests should be subject to tax at the time of transfer to the extent it was not taxed as it accrued. Under the current income tax, however, nominal (non-inflation adjusted) capital gains income is taxed when it is realized (sold or exchanged) by the taxpayer. Capital losses (within certain limits) are also deducted on a nominal basis when they are realized by the taxpayer. Currently, the untaxed appreciation in the value of capital assets transferred at death is not subject to tax.

Under current law, capital assets are separated into four categories. Assets that have been held for 12 months or less are considered short-term assets. Assets that have been held longer than 12 months are considered long-term assets. Collectibles (art work, antiques, coins, stamps, etc.) are the third category of assets and the fourth category of capital gains assets includes the portion of gain attributable to previously taken depreciation deductions on section 1250 property (depreciable real estate). Short-term capital gains are taxed at regular income tax rates. Long-term capital gains are taxed at a maximum tax rate of 20%. The tax rate is 10% for long-term gains that would have been taxed at a 15% regular tax rate. Collectibles held longer than 12 months are taxed at 28%. The un-recaptured section 1250 gain attributable to depreciation deductions is taxed at a maximum tax rate of 25%.

Effective for taxable years beginning in 2001, assets that have been held for at least 5 years and would have been taxed at a 10% tax rate will be taxed at an 8% tax rate. For assets which are held more than 5 years and whose holding period begins after December 31, 2000, the maximum tax rate will be 18% rather than 20%. Net capital losses are deductible against up to $3,000 of ordinary income, that is, non-capital gain income. Any portion of the net loss in excess of the $3,000 limit can be carried forward and used to offset gains in succeeding tax years. Excess net losses can be carried forward indefinitely and without limit on the amount of losses that can be carried forward.

Under current law, taxpayers are allowed to exclude from taxable income up to $500,000 ($250,000 in the case of single returns) of the gain from the sale of their principal residences. To qualify the taxpayer must have owned and occupied the residence for at least 2 of the previous 5 years prior to the date of sale. Under current law, capital gains transferred at time of death are not subject to tax. On transfer at death, the basis of the asset (original cost plus changes in the value due to improvements or depreciation) is stepped up to the market value of the asset on the date of death.

For further information, see CRS Report 98-473, *Individual Capital Gains Income: Legislative History*; CRS Report 96-769, *Capital Gains Taxes: An Overview*; and CRS Report RL30040, *Capital Gains Taxes, Innovation and Growth.*

Tax Treatment of Savings

The appropriate tax treatment of saving has been one of the most prominent tax policy debates in recent decades, continuing into the 106th Congress. It subsumes such topics as individual retirement accounts (IRAs), capital gains taxes, investment incentives, and corporate income taxes, to list just a few of its particular incarnations. The issue of savings has links to both economic performance and equity, which has helped make it controversial. An increased saving rate generally increases the country's capital stock, which in turn makes possible higher economic growth and a higher standard of living in the future. If tax incentives can boost saving, targeted tax cuts may thus be able to boost economic growth. On the other hand, income from investments is a higher proportion of income at higher income levels; tax benefits for saving thus reduce the progressivity of the tax system.

Economics suggests that the efficacy of tax incentives for saving depends heavily on how responsive individuals' savings rates are to changes in the rate of return to saving, after taxes. If individuals respond to tax incentives by increasing their saving, tax benefits may be an effective tool for increasing economic growth. On the other hand, if saving is unresponsive to targeted tax cuts, their efficacy is questionable. Unhelpfully, economic theory provides no clear answer and instead identifies two countervailing effects of tax incentives for saving. One effect (known as the substitution effect) leads individuals to save more because the aftertax rate of return has increased; a second effect (the income effect) works in the opposite direction, because a tax cut enables an individual to reach a given savings target with a lower savings rate.

The ambiguity of economic theory in this case passes the burden of proof to empirical evidence, and there have indeed been a plentitude of statistical studies. But taken as a group, these studies too produce no clear answer; some find a positive and significant relationship between tax incentives and saving — that is, they find that targeted tax cuts increase saving. Other studies find no relationship, and still others find a negative relationship. Thus, the impact of taxes on saving is unproved. However, even if individuals were to respond positively to savings incentives, that does not necessarily mean incentives are good economic policy. First, what matters for economic growth is not simply private saving but national saving — that is, the private saving rate minus any government dissaving by means of a budget deficit. Thus, the effect of tax cuts for saving in reducing government tax revenue may at least partly offset any positive effect they may have on private saving. Second, even though increased saving produces higher standards of living in the future, a tax-induced distortion that increases saving may not actually increase economic welfare. Absent market failures, economic theory suggests a tax is more efficient the less it changes behavior. And if saving is unresponsive to tax changes, it may be less damaging to economic welfare than alternative sources of tax revenue. Again, however, evidence on the responsiveness of saving is conflicting. Indeed, this summarizes what economics has to say about tax incentives for saving: theory and evidence on the efficacy of savings incentives is ambiguous and conflicting.

Tax benefits for saving in the current tax code are numerous. Among the most prominent are Individual Retirement Account (IRAs), 401(k) retirement savings plans and other qualified employer-sponsored retirement plans, life insurance policies and annuities, qualified state tuition programs, and medical savings accounts (MSAs). In addition, the favorable tax treatment of owner-occupied housing can be thought of as a saving incentive, as can the reduced tax rates for capital gains under the individual income tax.

For further information, see CRS Report RL30255. *Individual Retirement Accounts (IRAs): Issues, Proposed Expansion and Universal Savings Accounts (USAs)*

Tobacco Taxes

The Balanced Budget Act of 1997 (the BBA; PL. 105-33) provided a substantial increase in the federal excise tax on tobacco products. Beginning in 2000, the BBA provided a 10-cent per pack increase in the federal excise tax on cigarettes, thus raising the tax from prior law's 24 cents per pack to 34 cents; the act increased taxes on other tobacco products — for example, cigars, chewing tobacco, snuff, and pipe tobacco — by the same proportion. Effective in 2002, the BBA scheduled an increase in the tax by an additional 5 cents per pack, and a proportional increase in the other tobacco taxes.

A tentative tobacco settlement plan negotiated between the states and the tobacco industry, which would provide limits on future lawsuits in exchange for payments and other restrictions on the industry, led to a number of legislative proposals in the 105th Congress, including implementation of a tobacco settlement under federal law with a per pack fee similar to an excise tax. The Administration also proposed to raise $65.5 billion in revenue over 5 years (without specifying the exact collection method), amounting to about 54 cents per pack. The tobacco bill was not adopted. On November 17, 1998, the tobacco companies reached an independent agreement with most states for payments that amount to about 35 cents per pack. President Clinton proposed a substantial increase in the cigarette tax in both his FY2000 and FY2001 budgets. The proposal has not been adopted.

For further information, see CRS Report 98-84, *Tax Deductibility and the Proposed Tobacco Settlement*.

Fundamental Tax Reform Proposals (Including Flat Tax Plans)

The idea of replacing our current income tax system with a "flat-rate tax" is receiving renewed congressional interest. Although often referred to as "flat-rate taxes," many of the current proposals (introduced in the 104th, 105th, or 106th Congresses) go much further than merely adopting a flat-rate tax structure. Some involve significant income tax base-broadening while others entail changing the tax base from income to consumption. Most of the recent tax reform proposals (the Armey, Shelby, Domenici/Nunn, English, Specter, Lugar, Tauzin, Linder, Souder, Gramm, Faircloth, and Largent/Hutchinson plans) would change the tax base from income to consumption. Others are not consumption tax proposals. Representative Gephardt would keep income as the tax base but broaden the base and lower the tax rates. Representative Crane's proposal would levy a tax on the earned income of each individual as a replacement for the current individual income tax, corporate income tax, and estate and gift taxes. Former Representative Snowbarger's proposal would permit each taxpayer to choose between the current individual income tax return and an alternative individual tax return with a flat rate. Senator Dorgan's proposal would allow most taxpayers to choose between the current individual tax system and his "shortcut" tax plan under which taxes withheld would equal the employee's tax liability.

The flat tax controversy has focused on shifting from the present system, which is predominantly an income tax system, to a consumption tax system as a way to raise the savings rate, improve economic efficiency, and simplify the tax system. There is, however, no conclusive empirical evidence that a consumption tax will or will not increase the personal

savings rate and consequently the level of national savings. Highly stylized life-cycle models show that a consumption tax would cause a substantial increase in the savings rate, but these models are controversial because of their idealized assumptions. To raise the same amount of tax revenue, a consumption-based tax would require higher marginal tax rates than would an income tax (since consumption is smaller than income). Distortions caused by these higher marginal rates could offset (or even exceed) other advantages of the consumption tax. Hence, whether an income tax system or a consumption tax system is more efficient is unknown.

Proponents of some flat tax proposals argue that integration of the current corporate and individual income taxes as well as simple returns would result from a consumption tax. The current income tax system is complex. The federal tax code and the federal tax regulations are lengthy and continue to expand. However, in tax year 1996, approximately 70% of individual taxpayers took the standard deduction, which made complexity less relevant. Finally, some argue that it is unfair to compare the current income tax system with an uncomplicated, "pure" consumption tax that could become complicated by the time it is enacted.

It has been argued that some flat tax proposals would reduce the balance-of-trade deficit since imports would be taxed but the tax would be rebatable on exports. Economic theory, however, suggests that border tax adjustments have no effect on the balance-of-trade because the balance-of-trade is a function of international capital flows; border tax adjustments would be offset by exchange rate adjustments.

The United States is the only developed country without a broad-based consumption tax at the national level. Other developed nations have adopted broad-based consumption taxes, but as adjuncts rather than as replacements for their income based taxes.

For further information, see CRS Issue Brief IB95060, *Flat Tax Proposals: An Overview*.