

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue top and bottom. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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*Certain Temporary Tax Provisions ("Extenders") Expired in  
2007*

Pamela J. Jackson, Government and Finance Division; Jennifer Teefy, Knowledge Services Group

October 8, 2008

**Abstract.** This report discusses the nature of extenders, as temporary provisions and as tax benefits. Descriptions of the extenders are included.

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# CRS Report for Congress

## Certain Temporary Tax Provisions (“Extenders”) Expired in 2007

**Updated October 8, 2008**

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**Prepared for Members and  
Committees of Congress**

# Certain Temporary Tax Provisions (“Extenders”) Expired in 2007

## Summary

Several temporary tax provisions expired on December 31, 2007. Often referred to as “extenders,” these provisions were originally enacted with expiration dates that have subsequently been extended, in some cases numerous times. The temporary nature of extenders can be considered useful as it allows policymakers to evaluate the effectiveness of the provisions on a regular basis. If an extender is found to be ineffective, its scheduled expiration allows several policymaking options, including allowing the provision to expire or redesigning the provision to improve its use as a policy tool. However, policymakers have, for the most part, considered the extenders as a group during the enactment process, and have not reviewed the unique strengths and weaknesses of specific provisions.

The extenders include tax credits, which are the Work Opportunity Tax Credit (WOTC), the Welfare-to-Work Tax Credit (WWTC), an election to include combat pay as earned income for purposes of the earned income credit, the tax credit for holders of qualified zone academy bonds, the tax credit for first-time homebuyers in the District of Columbia, the tax credits for research and experimentation expenses, the New Markets Tax Credit, the possession tax credit with respect to American Samoa, and a credit for certain Expenditures for Maintaining Railroad Tracks. The extenders include deductions, which are for elementary and secondary school teachers; tuition expenses; mortgage insurance premiums; corporate charitable contributions of computer technology, food inventory, and books; contributions of capital gain real property made for conservation; and state and local sales taxes. Also included are depreciation allowances for qualified leasehold and restaurant improvements, for property on Indian reservations, and a seven-year recovery period for motor sports entertainment complexes. Other temporary tax provisions that expired included tax incentives for investment in the District of Columbia, an increased “cover over” of tax on distilled spirits from Puerto Rico and the U.S. Virgin Islands, penalty-free withdrawals from individual retirement plans (IRAs) for individuals called to active duty or for charitable giving, and mortgage revenue bonds for veterans.

Division C of P.L. 110-343, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which was signed into law on Friday, October 3, 2008, retroactively extends several temporary tax provisions for individuals and businesses through December 31, 2009.

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

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# Certain Temporary Tax Provisions (“Extenders”) Expired in 2007

## Introduction

Several temporary tax provisions expired in 2005 and were retroactively extended by the Tax Relief and Health Care Act of 2006 (P.L. 109-432; TRHCA) through December 31, 2007. Often referred to as “extenders,” these provisions were originally enacted with an expiration date that has then been temporarily extended, in some cases numerous times. The extenders provided special tax treatment for certain types of activities and investment; they benefitted both individuals and corporations. The extenders included credits, deductions, and other provisions.

The extenders include tax credits, which are the Work Opportunity Tax Credit (WOTC), the Welfare-to-Work Tax Credit (WWTC), an election to include combat pay as earned income for purposes of the earned income credit, the tax credit for holders of qualified zone academy bonds, the tax credit for first-time homebuyers in the District of Columbia, the tax credits for research and experimentation expenses, the New Markets Tax Credit, the possession tax credit with respect to American Samoa, and a credit for certain Expenditures for Maintaining Railroad Tracks.

The extenders include deductions, which are for elementary and secondary school teachers; tuition expenses; mortgage insurance premiums; corporate charitable contributions of computer technology, food inventory, and books; contributions of capital gain real property made for conservation; and state and local sales taxes. Also included are depreciation allowances for qualified leasehold and restaurant improvements, for property on Indian reservations, and a seven-year recovery period for motor sports entertainment complexes.

Other temporary tax provisions that expired included tax incentives for investment in the District of Columbia, an increased “cover over” of tax on distilled spirits from Puerto Rico and the U.S. Virgin Islands, an excise tax to induce parity in the application of certain mental health benefits, penalty-free withdrawals from individual retirement plans (IRAs) for individuals called to active duty or for charitable giving, and mortgage revenue bonds for veterans.

## Developments in the 110<sup>th</sup> Congress

In the 110<sup>th</sup> Congress, attention on minimum wage hikes led to proposals to increase tax incentives for small businesses. The tax packages were designed as offsets to aid businesses that may be adversely impacted by higher wage costs associated with the minimum wage increase. Originally introduced in H.R. 2, the

Fair Minimum Wage Act of 2007, and S. 248, the Small Business and Work Opportunity Acts of 2007, certain temporary provisions were most recently added to the conference report for H.R. 1591, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007. H.R. 1591 passed both the House and Senate in March 2007 and the conference report passed in both chambers in April 2007. H.R. 1591 was presented to the president and vetoed. Subsequently, the tax and minimum wage provisions were added to H.R. 2206, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, which was introduced on May 8, 2007. While H.R. 2206 became law (P.L. 110-28) in May 2007, several of the original tax provisions in H.R. 1591 were not included in the final legislation. The temporary tax provision that was included in the law was an extension of the Work Opportunity Tax Credit through August 31, 2011.

H.R. 3648, which was signed into law on December 20, 2007 (P.L. 110-142), extends the deduction of qualified mortgage insurance premiums provision through December 31, 2010. H.R. 6, which became law on December 19, 2007 (P.L. 110-140), extends the Federal Unemployment Tax Act 0.2% surtax through December 31, 2008.

Proposals for one-year extensions of several temporary tax provisions have been included in H.R. 3996, the Temporary Tax Relief Act of 2007, which was passed in the House on November 9, 2007, and H.R. 3970, the Tax Reduction and Reform Act of 2007.

H.R. 6049, the Energy and Tax Extenders Act of 2008, as passed in the House on May 21, 2008, proposes a one-year extension through 2008 for many of the expiring temporary tax provisions, except for the expensing rules for qualified film and television productions, look-thru rule for related controlled foreign corporations, Subpart F exception for active financing income, and the new markets tax credit, which would be extended for two years through 2009. In addition, the House-passed version of H.R. 6049 would make several provisions permanent, including the authority for undercover operations, disclosure of information relating to terrorist activities, and authority to disclose return information for certain veterans programs. S. 3335, the Jobs, Energy, Families, and Disaster Relief Act of 2008, makes similar proposals.

S. 2886, the Alternative Minimum Tax and Extenders Tax Relief Act of 2008 proposes a two-year extension through 2009 for all of the temporary tax provisions contained in the bill, except the authority for undercover operations, which would be made permanent. S. 3098, also titled the Alternative Minimum Tax and Extenders Tax Relief Act of 2008 and introduced on June 6, 2008, would extend many expiring tax provisions for two years through 2009. Unlike S. 2886, S. 3098 does not include provisions that raise revenue to offset the costs of the tax proposals made in the bill.

H.R. 7060 and H.R. 7202, introduced on September 25 and September 28, 2008, respectively, would extend many temporary provisions for two years, and several for one year. Both bills also reauthorize Qualified Zone Academy Bonds (QZABs), and allow an additional \$400 million in issuing authority to state and local governments in 2008 and 2009. H.R. 7060 passed the House on September 26, 2008.

Division C of P.L. 110-343, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which was signed into law on Friday, October 3, 2008, retroactively extends several temporary tax provisions for individuals and businesses through December 31, 2009. That legislation also includes revenue offsets along with disaster relief for the Midwest flood stricken areas and the areas in Texas and Louisiana devastated by Hurricane Ike.

## Tax Credits

- Indian employment tax credit
- Inclusion of combat pay as earned income for purposes of earned income tax credit
- Tax credit for holders of qualified zone academy bonds
- Tax credit for research and experimentation
- New markets tax credit
- Credit for certain railroad track maintenance expenditures

## Tax Deductions

- Expense deduction for elementary and secondary school teachers
- Deduction for qualified tuition and related expenses
- Enhanced deduction for corporate contributions of computer equipment for educational purposes
- Enhanced deduction for contributions of food inventory
- Enhanced deduction for contributions of book inventory to public schools
- Basis adjustment to stock of S corporations making charitable contributions of property
- Contributions of capital gain real property made for conservation purposes
- Expensing of “brownfields” environmental remediation costs
- State and local sales tax deduction
- 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property
- Accelerated depreciation for property on Indian reservations
- Seven-year cost recovery period for motor sports entertainment complexes

## Other Tax Provisions

- Tax incentives for investment in the District of Columbia (“D.C. Enterprise Zone”)
- “Cover over” of tax on distilled spirits to Puerto Rico and the U.S. Virgin Islands
- Parity in the application of certain limits to mental health benefits
- Penalty-free withdrawals (distributions) from retirement plans for individuals called to active duty
- Tax-free distributions from individual retirement plans for charitable purposes



- Use of qualified mortgage bonds to finance residences for veterans without regard to first-time homebuyer requirement

## Analysis

Several tax provisions expired in 2005, were retroactively extended in late 2006 through 2007, and are now expired again. Many of the provisions had been extended at least twice since their original expiration date. Among the extenders, one provision was 20 years old, another was 10 years old, and nine other provisions had been in existence for five years or more. The durability of the extenders suggests they may be more than temporary in nature.

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

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

Extenders, like all tax benefits, affect revenue estimation as well. Budget estimates are required to be made assuming current law proceeds uninterrupted. As a result, revenue projections are made assuming temporary tax provisions expire according to current law. Thus, if temporary provisions are frequently extended automatically, revenue projections may be inaccurate. An example that illustrates this point is when tax writers are looking for revenue offsets to balance tax cuts. In the 108<sup>th</sup> Congress, legislation (H.R. 6) proposed several incentives for energy production. Some of the cost of those incentives was intended to be offset by a \$10 billion increase in expected tax revenue for 2009 through 2014 from an ethanol tax

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

credit set to expire in 2008. If the credit is extended rather than allowed to expire, the revenue projection for those years is overstated.<sup>2</sup>

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

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

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

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

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

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

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

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

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

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

Another component of fairness in taxation is vertical equity, which requires that tax burdens be distributed fairly among people with different abilities to pay. Most

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

extenders benefit those who have sufficient income to pay tax. Those individuals without sufficient income to pay tax do not have the opportunity to benefit from extenders. The disproportionate benefit of tax expenditures to individuals with higher incomes reduces the progressivity of the tax system, which is often viewed as a reduction in equity.

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

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

## Temporary Tax Credits

Some of the temporary provisions scheduled to expire are tax credits, which are incentives that, when claimed, reduce the taxpayer's income tax liability. In general, a tax credit is more valuable than a similar tax deduction. A tax credit reduces the tax paid, dollar-for-dollar. Tax deductions lower taxable income.

**Table 1. Tax Credits**

Provision	Internal Revenue Code Section
Work Opportunity Tax Credit	51(c)(4)
Welfare-to-Work Tax Credit	51A(f)
Indian Employment Tax Credit	45A(f)
Inclusion of combat pay as earned income for EITC	32(c)(2)(B)(vi)(II)
Tax credit for holders of qualified zone academy bonds	1397E(e)(1)
Tax credit for first-time D.C. homebuyers	1400C(i)
Tax credit for research and experimentation	41(h)
New Markets Tax Credit	45(d)

Provision	Internal Revenue Code Section
Possession Tax Credit with respect to American Samoa	27(b), 936
Credit for Certain Railroad Track Expenditures	45G(f)

Source: CRS

## Employment Tax Credits

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

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

The WOTC was extended through August 31, 2011, by the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (P.L. 110-28). That legislation also established a new targeted group of eligible employees for the credit. Individuals are designated as community residents, rather than high risk youth and are required to be between 18 and 40 in age and have a principal place of abode in an empowerment zone, enterprise community, renewal community, or rural renewal community (defined as an area outside a metropolitan statistical area that has had a net population loss during specified periods).

**Welfare-to-Work Tax Credit (WWTC).** This nonrefundable credit is available to private sector, for-profit employers who hire long-term recipients of TANF benefits. During the first year in which WWTC-eligible persons are hired, employers can claim an income tax credit of 35% of the first \$10,000 earned by the employee. The employer can claim an income tax credit of 50% of the first \$10,000

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

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

The Tax Relief and Health Care Act of 2006 (P.L. 109-432; TRHCA) included a combination and modification of the two credits along with an extension through December 31, 2007.

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

The Indian employment credit was enacted by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) and extended twice, by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-47) and the Working Families Tax Relief Act of 2004 (P.L. 108-311). TRHCA enacted an extension through December 31, 2007.

## **Inclusion of Combat Pay as Earned Income for Purposes of Earned Income Credit**

The earned income tax credit (EITC) is a refundable tax credit for eligible low income workers.<sup>5</sup> The amount of EITCs received by childless adults or families with

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

<sup>5</sup> For more detailed information, see CRS Report RL31768, *The Earned Income Tax Credit* (continued...)

children is based on income and age of the earner(s). “Earned income,” for the purposes of the EITC, includes taxable wages, salaries, tips, and other employee compensation. Combat pay, under Internal Revenue Code, Sec. 112, is generally excluded from income for tax purposes; therefore, some low income military families who receive the EITC based on taxable military pay could lose this tax credit if they begin receiving non-taxable combat pay.

As a result of sustained deployments in Iraq, some military households eligible for the EITC were unable to claim it because of high combat pay earnings. A temporary provision was included in the Working Families Tax Relief Act of 2004 (P.L. 108-311), effective for tax years beginning after October 4, 2004, and ending on December 31, 2005, allowing members of the military to include combat pay in earned income for the purposes of calculating the EITC. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended this temporary combat pay/EITC provision through the end of 2006, and the TRHCA extended it through the end of 2007.

The Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245, signed in June 2008) made the election permanent.

## **Tax Credit for Holders of Qualified Zone Academy Bonds**

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

Initially, state and local governments could issue QZABs only in 1998 and 1999, subject to a national limitation of \$400 million each year. The Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106-170, extended this provision, authorizing up to \$400 million of QZABs to be issued in 2000 and 2001, with any unused authority carried over for several years. The Job Creation and Worker Assistance Act of 2002, (P.L. 107-47), extended the QZAB program with an additional \$400 million of bond capacity available for 2002 and 2003. The Working Families Tax Relief Act of 2004 (P.L. 108-311) authorized an additional extension through December 31, 2005.<sup>6</sup> TRHCA enacted a two-year extension of the provision, through December 31, 2007.

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<sup>5</sup> (...continued)  
(EITC), *An Overview*, by Christine Scott.

<sup>6</sup> For more detailed information, see CRS Report RS20606, *Tax Credit Bonds: A Brief Explanation*, by Steven Maguire.

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

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

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

## Tax Credit for Research and Experimentation Expenses

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

The R&E tax credit, originally enacted in the Economic Recovery Tax Act of 1981 (P.L. 97-34), has been extended 11 times, most recently by the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) and by the Working Families Tax Relief Act of 2004 (P.L. 108-311). TRHCA retroactively extended the tax credit, through December 31, 2007, and modified the credit rules.<sup>8</sup>

At least six bills have been introduced in the 110<sup>th</sup> Congress that would modify the research tax credit: S. 14, S. 41, S. 592, S. 833, H.R. 1712, and H.R. 2138. All would extend the credit, S. 14, S. 41, S. 833, H.R. 1712, and H.R. 2138 permanently and S. 592 through 2012. Among other amendments, H.R. 1712 and S. 41 modify the tax credit by establishing a standard 20% credit rate for research expenses exceeding 50% of average expenses over the preceding three-year period.<sup>7</sup>

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

<sup>8</sup> For more detailed information on the Research and Experimentation Tax credit, including its design, legislative history, effectiveness, and key policy issues, see CRS Report RL31181, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress*, by Gary Guenther.



## New Markets Tax Credit

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

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

## Possession Tax Credit with Respect to American Samoa

Section 936 of the Internal Revenue Code allows certain domestic corporations with business operations in the U.S. possessions, including American Samoa. The tax credit is intended to offset the U.S. tax imposed on certain income related to operations in American Samoa. Income eligible for the Section 936 credit includes non-U.S. source income from the active conduct of a trade or business within a U.S. possession, the sale or exchange of substantially all of the assets that were used in such a trade or business, or certain possessions investments. The Section 936 credit expired for taxable years beginning after December 31, 2005.

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

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

TRHCA extended the credit through December 31, 2007.

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<sup>9</sup> For more detailed information, see CRS Report RL34402, *New Markets Tax Credit: An Introduction*, by Donald J. Marples.

## Credit for Certain Railroad Track Maintenance Expenditures

A 50% general business credit<sup>10</sup> is available to eligible taxpayers for qualified railroad track maintenance expenditures paid or incurred in tax years beginning after December 31, 2004, and beginning before January 1, 2008. The purpose of the credit is to enable small and mid-sized railroads to update and upgrade their track capacities in order to promote those railroads as an alternative to shipping freight on roadways.

The railroad track maintenance credit cannot exceed the product of \$3,500 and the number of miles of railroad track owned or leased by or assigned to the eligible taxpayer (e.g., \$3,500 x 200 miles). Eligible taxpayers include Class II and III railroads<sup>11</sup> and certain persons who are assigned tracks by a Class II or Class III railroad. Qualified railroad track maintenance expenditures include expenses for maintaining railroad track owned or leased, as of January 1, 2005, by a Class II or Class III railroad.

The railroad track maintenance credit was introduced by the American Jobs Creation Act of 2004 (P.L. 108-357).

## Temporary Tax Deductions

Temporary tax deductions include provisions for individuals and corporations.

**Table 2. Tax Deductions**

Provision	Internal Revenue Code Section
Expense deduction for elementary and secondary school teachers	62(a)(2)(D)
Deduction for tuition and related expenses	222
Deduction for mortgage insurance premiums	163(h)(3)(E)(iv)(I)
Enhanced deduction for corporate contributions of computer equipment for educational purposes	170(e)(6)(G)
Enhanced deduction for contributions of food inventory	170(e)(3)(C)(iv)

<sup>10</sup> The general business credit includes a number of credits designed to encourage certain business activities.

<sup>11</sup> The U.S. Department of Transportation's Surface Transportation Board's regulations divide railroads into three classes based on annual carrier operating revenues. Class I railroads are those with annual carrier operating revenues of \$250 million or more (in 1991 dollars); Class II railroads are those with annual carrier operating revenues of more than \$20 million but less than \$250 million (in 1991 dollars); and Class III railroads are those with annual carrier operating revenues of \$20 million or less (in 1991 dollars). See 49 CFR Part 1201, General Instruction 1-1(a).

<b>Provision</b>	<b>Internal Revenue Code Section</b>
Enhanced deduction for contributions of book inventory to public schools	170(e)(3)(D)(iv)
Basis adjustment to stock of S corporations making charitable contributions to charity	1367(a)(2)
Contributions of capital gain real property made for conservation purposes	170(b)(1)(E)(vi)
Expensing of “brownfields” environmental remediation costs	198(h)
Contributions to Archer medical savings accounts	220(i)
Suspension of income limitation on percentage depletion for oil and gas from marginal wells	613A(c)(6)(H)
State and local sales tax deduction	164
15-year straight-line cost recovery for qualified leasehold improvements	168(e)(3)(E)(iv)
15-year straight-line cost recovery for qualified restaurant improvements	168(e)(3)(E)(v)
Accelerated depreciation for property on Indian reservations	168(j)
Seven-year cost recovery period for motor sports entertainment complexes	168(i)(15)(D)

Source: CRS

## **Expense Deduction for Elementary and Secondary School Teachers**

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

TRHCA retroactively extended the deduction for two years, through December 31, 2007.

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<sup>12</sup> For more detailed information see CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*, by Linda Levine.

## Deduction for Tuition and Related Expenses

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

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

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

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

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

TRHCA retroactively extended the deduction for two years, through December 31, 2007.

## Premiums for Mortgage Insurance Deductible as Interest that is Qualified Residence Interest

Mortgage insurance, which guarantees loan repayment in case of death or disability of the borrower, is often required by lenders for individuals who do not have sufficient funds for a full down payment on a residence. Premiums paid or accrued for qualified insurance on mortgage loans can be treated as qualified residence interest<sup>13</sup> and deducted from income tax. “Qualified mortgage insurance” is mortgage insurance provided by the Veterans Administration (VA), the Federal Housing Administration (FHA), the Rural Housing Administration (RHA), and private mortgage insurance as defined under Section 2 of the Homeowners Protection Act of 1998 (12 U.S.C. Sec. 4901).

The deduction of qualified mortgage insurance premiums generally applies to amounts paid or accrued only during the tax years 2007 through 2010, with respect to contracts issued during those same years; the provision terminates for premiums paid or accrued after December 31, 2010. This deduction is also subject to a phaseout. For every \$1,000, or fraction thereof, by which the taxpayer’s adjusted gross income exceeds \$100,000, the amount of deductible mortgage insurance premiums is reduced (but not below zero) by 10%. In the case of a married taxpayer filing separately, the amounts are lowered to \$500 and \$50,000. The purpose of this phaseout is to prevent taxpayers with adjusted gross incomes greater than \$109,000 (\$54,500 for a married taxpayer filing separately) from claiming this tax benefit.

Prepaid mortgage insurance amounts that are allocable to periods beyond the year in which they are paid are attributed to a capital account and treated as paid in the allocable year (contracts issued by the VA or RHA are excluded from this provision). If the mortgage is paid off before the end of its term, a deduction is not allowed for the unamortized balance of the capital account.

Premiums paid for mortgage insurance were not deductible in the past, and this new, temporary provision was added by the Tax Relief and Health Care Act of 2006 (P.L. 109-432). In the 110<sup>th</sup> Congress, H.R. 3648, which was signed into law on December 20, 2007 (P.L. 110-142), extends this provision through December 31, 2010.

## Enhanced Deduction for Corporate Charitable Contributions of Computer Equipment for Educational Purposes

Section 170(e)(6) of the Internal Revenue Code allows for an enhanced deduction for corporate contributions of computer equipment to public libraries and elementary and secondary schools. Generally, tax law allows for certain

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<sup>13</sup> The qualified residence interest deduction is a permanent provision which allows taxpayers to deduct interest accrued or paid on mortgage or home equity loans for qualified residences. A qualified residence is generally defined as the taxpayer’s primary residence or his second home. For more detailed information, see CRS Report RL33025, *Fundamental Tax Reform: Options for the Mortgage Interest Deduction*, by Pamela J. Jackson.

contributions of inventory or other ordinary-income property, and short-term capital gain property to be made by C corporations<sup>14</sup> (S corporations,<sup>15</sup> which are taxed as partnerships, are not eligible). In the case of charitable contributions, the amount of the deduction is limited to the taxpayer's basis (original investment) in the property. Special rules provide enhanced deductions for certain corporate contributions of inventory property for the care of the ill, the needy or infants and certain contributions of scientific equipment. Under these special rules, the amount of the enhanced deduction is equal to the donor's basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold.

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

Originally authorized by the Taxpayer Relief Act of 1997 (P.L. 105-34), the provision was then extended for three years by the Community Renewal Tax Relief Act of 2000 (CRTRA, P.L. 106-554). CRTRA also expanded the deduction to include property donated to public libraries, property donated no later than three years (instead of two) after the date of taxpayer acquisition, and property donated after reacquisition by computer manufacturers. The most recent extension, through December 31, 2005, was authorized by the Working Families Tax Relief Act of 2004 (P.L. 108-311). TRHCA retroactively extended the deduction for two years, through December 31, 2007.

## **Enhanced Deduction for Contributions of Food Inventory**

Tax law provides an enhanced deduction for certain charitable contributions of food inventory. This deduction has been limited to contributions made by a certain type of corporation, C corporations. The value of the existing deduction is the corporation's basis in the donated product plus one half of the amount of appreciation, as long as that amount is less than twice the corporation's basis in the product.

In general, if a charitable contribution is made in the form of property, the basis for the charitable deduction is dependent on the type of taxpayer (i.e., individual or form of business entity), to whom the property is donated, and for what purpose the donated property is to be used.

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<sup>14</sup> The Internal Revenue Code normally subjects corporate profits to the corporate income tax under its subchapter C; corporations subject to income tax are thus often referred to as "C corporations."

<sup>15</sup> S corporations are not subject to the corporate income tax and their net profits are passed through to the individual shareholders (partners), the number of which must be limited to 75 or less, who are taxed on the profits under the individual income tax.

Corporate gifts of property that would generate capital gains if sold (e.g., stocks and bonds) are deductible by corporations at market value. However, gifts of depreciable property are deductible at the corporation's basis rather than fair market value. Thus, under current tax law, the deduction is reduced by previously taken depreciation. In the case of fully depreciated machinery and equipment, the allowable charitable contribution deduction would be zero.

Under current tax law, C corporations are provided more favorable tax treatment of contributions of certain types of inventory and other ordinary-income property to specified charitable organizations. This provision is temporarily available to S corporations, partnerships, and sole proprietorships. Through 2007, all donors are allowed to deduct their cost plus one-half the difference between their cost and the market value of the donated goods. However, in no case may the deduction's value exceed twice the cost basis.

For a donor to receive this enhanced deduction, the gift must be made to a "qualified" tax exempt organization. Further, the property must be "used by the donee solely for the care of the ill, the needy, or infants."<sup>16</sup> The donee is not permitted to exchange what has been transferred for money, other property, or services.<sup>17</sup> The donee must furnish to the donor a statement that it does not intend to transfer the donation and that it will be used for the care of the ill, the needy, or infants.<sup>18</sup> If the property is subject to regulation by the Federal Food, Drug, and Cosmetic Act it must satisfy the requirements on the date of transfer and for 180 days prior thereto.<sup>19</sup>

The enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined under the Katrina Emergency Tax Relief Act of 2005 (KETRA) as food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.<sup>20</sup>

In response to the devastation from Hurricane Katrina, the Katrina Emergency Tax Relief Act of 2005 (KETRA, P.L. 109-73) was enacted. That legislation included a temporary expansion of the tax deduction for charitable contributions of food inventory. The law allowed all donors of wholesome food inventory to benefit from the enhanced deduction for donations made between August 28, 2005, and January 1, 2006. The Pension Protection Act of 2006 (P.L. 109-280) extended the temporary expansion through January 1, 2008.

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<sup>16</sup> Internal Revenue Code §170(e)(3)(i).

<sup>17</sup> Internal Revenue Code §170(e)(3)(ii).

<sup>18</sup> Internal Revenue Code §170(e)(3)(iii).

<sup>19</sup> Internal Revenue Code §170(e)(3)(iiii).

<sup>20</sup> For more detailed information, see CRS Report RL31097, *Charitable Contributions of Food Inventory: Proposals for Change*, by Pamela J. Jackson.

## Enhanced Deduction for Contributions of Book Inventory to Public Schools

In response to the hurricane disasters along the Gulf coast in 2005, President Bush signed the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73), which temporarily modified the rules relating to charitable contributions in several ways, one being enhanced deductions for donations of book inventories to public schools. This provision was to terminate at the end of 2005 and was later extended to December 31, 2007, by the Pension Protection Act of 2006 (P.L. 109-280). Under this provision, any corporation (other than an S corporation<sup>21</sup>) that makes a qualified book contribution on or after August 28, 2005, and before January 1, 2008, may deduct its basis in the contributed property plus one-half of the property's appreciation in value, as long as the deduction does not exceed twice the property's basis. Before this enhanced deduction was enacted, companies could only deduct an amount equal to their cost for an item donated to a 501(c)(3) public charity (if the charity did not resell the item). However, the inventory or other property may have a fair market value higher than its cost.

A qualified book contribution is a charitable contribution of books to a public school that provides elementary or secondary education (kindergarten through grade 12) and maintains a regular faculty and curriculum with a regularly enrolled student body. The donee educational institution must certify that (1) the books are suitable in terms of currency, content, and quality for use in the school's educational programs, and (2) the school will actually use the books in its educational programs.

## Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property

A temporary tax incentive to encourage S corporations<sup>22</sup> to make charitable donations of appreciated assets is available for tax years 2006 and 2007. Generally, a charitable contribution of property by an S corporation provides the corporation's shareholders with a fair market value deduction for gifts of property. In association with the charitable gift, shareholders must reduce their basis (cost) of shares in the corporation. Under the temporary provision, the shareholder reduces his or her basis in the stock of the S corporation by his or her pro rata share of the adjusted basis of the contributed property, rather than by the fair market value of the charitable contribution that flows through to the shareholder. The lower basis reduction results in a proportionately larger gain when the stock is later sold by the shareholder. Thus, the shareholder benefits by having that reduction determined by the basis of the property (which is a smaller amount) rather than the fair market value (a larger amount). For example, if an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$100 and a fair market value of \$500, the shareholder will be treated as having made a \$500 charitable contribution and will reduce the basis of their S corporation stock by \$100.

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<sup>21</sup> See footnote 15 for the definition of an S corporation.

<sup>22</sup> See footnote 15 for the definition of an S corporation.



This provision was enacted by the Pension Protection Act of 2006 (P.L. 109-280).

## **Contributions of Capital Gain Real Property Made for Conservation Purposes**

This provision, introduced by the Pension Protection Act of 2006 (P.L. 109-280), provides incentives for individuals to make qualified conservation contributions of real estate and ownership interests in real estate during 2006 and 2007. The act raises the charitable deduction limit for individuals from 30% to 50% of adjusted gross income for qualified conservation contributions, and allows taxpayers to carry these deductions forward for 15 years.

A qualified conservation contribution is a contribution of qualified real property interest to a government or publicly supported charity (or organization that is controlled by a government or publicly supported charity) exclusively for conservation purposes.<sup>23</sup> Qualified real property interest is either the entire interest of the donor<sup>24</sup>, a remainder interest (which allows the donor to continue occupying the donated property during his or her lifetime), or a restriction (granted in perpetuity) on the use which may be made of the real property.

For qualified farmers or ranchers who contribute property used for agriculture or livestock production, the charitable deduction limit is raised to 100% of adjusted gross income, provided that such contribution does not prevent the use of the donated land for farming or ranching purposes. A “qualified farmer or rancher” is a taxpayer whose gross income from the trade or business of farming is greater than 50% of the taxpayer’s gross income for the taxable year.

Private corporations that are engaged in farming or ranching activities may deduct up to 100% of adjusted taxable income for such contributions, provided that the terms of the gift did not limit the farming activities on the property. Such corporations could also carryover the deduction for a 15-year period.

This provision was effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008. When the Food, Conservation, and Energy Act of 2008 (P.L. 110-234) was signed into law on May 22, 2008, the provision was extended for two years. Thus, contributions made in taxable years beginning before January 1, 2010, are eligible for the provision.

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<sup>23</sup> A qualified conservation contribution is one that is made for any one of the following four purposes: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public, or made pursuant to a clearly delineated federal, state, or local government conservation policy that will yield a significant public benefit; and (4) the preservation of a historically important or a certified historic structure.

<sup>24</sup> Other than qualified mineral interest, which means subsurface oil, gas, or other minerals, and the right to access these minerals.

## Expensing of “Brownfields” Environmental Remediation Costs

Section 198 of the Internal Revenue Code was created by the Taxpayer Relief Act of 1997 (P.L. 105-34) to allow firms that undertake certain expenditures to deduct those costs against income in the year incurred. The allowable expenditures were made to control or abate hazardous substances in a qualified contaminated business property. These expenditures would have otherwise been allocated to a capital account and could have been deducted only at some later point — for example, when the land was sold.

Expensing, or deducting against income, provides a tax subsidy for capital invested by business. By expensing hazardous control and abatement costs rather than capitalizing those costs, taxes on the income generated by the expenditures were effectively zero. This provision provides a financial incentive to businesses and encourages them to invest in the clean up and redevelopment of “brownfields,” which are abandoned industrial sites and dumps that would be cleaned up and redeveloped except for the prohibitive costs and complexities of environmental contamination.<sup>25</sup>

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

In the 109<sup>th</sup> Congress, both the House and Senate versions of H.R. 4297 as well as H.R. 5970 proposed to extend the provision for two years through December 31, 2007, and to expand the definition of hazardous substance to include petroleum products, which include crude oil, crude oil condensates, and natural gasoline.<sup>26</sup> TRHCA included the same proposal.

## Contributions to Archer Medical Savings Accounts

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

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<sup>25</sup> For more detailed information, see CRS Report RL34184, *The Section 198 Brownfields Tax Incentive: 2007 CRS Survey*, and CRS Report RS22575, *Brownfield Issues in the 110<sup>th</sup> Congress*, both by Mark Reisch.

<sup>26</sup> U.S. Congress, Joint Committee on Taxation, *Description of H.R. 4297, A Bill to Provide for Reconciliation Pursuant to Section 201(b) of the Concurrent Resolution on the Budget for Fiscal Year 2006*, 109<sup>th</sup> Cong., 2<sup>nd</sup> sess., JCX-75-05 (Washington: GPO, 2005), p. 35.

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

Archer MSAs have not attracted many participants. The number of existing Archer MSAs has never come close to the limit of 750,000 accounts. In October 2002, the IRS estimated that there would be 78,913 Archer MSA returns filed for tax year 2001; it also determined that 20,592 taxpayers newly established Archer MSA accounts in 2002. This low participation rate may have been influenced by several factors. Archer MSAs may not have appealed to certain categories of individuals. Those with chronic illnesses were more likely to desire low-deductible health plans that would have been ineligible for the program. Low-income individuals, being unwilling to incur high out-of-pocket costs, may have chosen low-deductible health plans. Additionally, individuals with other health plan options through their employer or community would not be eligible to participate.<sup>27</sup>

After 2002, no new contributions were to be made to Archer MSAs, except by or on behalf of individuals who previously made Archer MSA contributions, by employees of small employers, and by self-employed individuals with prior Archer MSA participation. Thus, taxpayers who participated in the programs could continue, but no new accounts could be opened. The Job Creation and Worker Assistance Act of 2002, P.L. 107-147, extended this provision for an additional year through December 31, 2003. The next extension, through December 31, 2005, was authorized by the Working Families Tax Relief Act of 2004 (P.L. 108-311). TRHCA retroactively extended the deduction for two years, through December 31, 2007.

## **Special Rules for Deduction for Oil and Gas from Marginal Wells**

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

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<sup>27</sup> For more detailed information, see CRS Report RS21573, *Tax-Advantaged Accounts for Health Care Expenses: Side-by-Side Comparison*, by Bob Lyke and Chris L. Peterson.

This tax incentive, designed to be a production subsidy, was criticized by some observers as inefficient. As a subsidy, the incentive was intended to increase investment exploration and output. In the short-run, it may have some impact on reducing dependence on imported oil. In the long-run, critics maintain that the provision may have contributed to a faster depletion of resources by encouraging swift development of existing properties.<sup>28</sup>

Initially enacted by the Taxpayer Relief Act of 1997, P.L. 104-34, the 100% taxable income limitation suspension has been extended three times, by the Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106-170; by the Job Creation and Worker Assistance Act of 2002. The most recent extension, through December 31, 2005, was authorized by the Working Families Tax Relief Act of 2004 (P.L. 108-311). TRHCA retroactively extended the deduction for two years, through December 31, 2007.

## State and Local Sales Tax Deduction

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

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

The term “general sales tax” means a tax imposed at one rate with respect to the retail sale of a broad range of classes of items. However, in the case of certain items, like food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items. The fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate.<sup>29</sup>

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

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<sup>28</sup> For more detailed information see CRS (archived) Report RL32265, *Expired and Expiring Energy Tax Incentives*, by Salvatore Lazzari, available from author upon request.

<sup>29</sup> For more detailed information see CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire.

31, 2006. TRHCA retroactively extended the deduction for two years, through December 31, 2007.

## Depreciation Allowances

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

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

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

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

TRHCA extended the provisions to apply to property placed in service through December 31, 2007.

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

**Table 3. Accelerated Depreciation for Property**

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

The accelerated depreciation provision requires that property be used in the active conduct of business within an Indian reservation. The provision was enacted by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) and extended by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-47). TRHCA extended the accelerated provision through December, 31, 2007.

**Seven-Year Cost Recovery Period for Motor Sports Entertainment Complexes.** Taxpayers generally capitalize the cost of property used in a trade or business and recover such cost over 15 years. An exception exists, however, for the theme and amusement park industry, whose assets are assigned a seven-year recovery period.

The American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) assigned a seven-year modified accelerated cost recovery period to motorsports entertainment complexes, which include land improvements and support facilities, but not transportation equipment, warehouses, administrative buildings, hotels, or motels.

The provision is effective for property placed in service after October 22, 2004, and before 2008. The AJCA specifies that the provision applies to motorsports entertainment complexes permanently situated on land and, during the 36-month period following the first day of the month in which the facility is placed in service, hosts one or more racing events for automobiles (of any type), trucks, or motorcycles which are open to the public for the price of admission. Also covered by the provision are any ancillary facilities and land improvements in support of the complex's activities (including parking lots, sidewalks, waterways, bridges, fences, and landscaping); support facilities (including food and beverage retailing, souvenir vending, and other non-lodging accommodations); and appurtenances associated with such facilities and related attractions and amusements (including ticket booths, race track surfaces, suites and hospitality facilities, grandstands and viewing structures, props, walls, facilities that support the delivery of entertainment services, other special purpose structures, facades, shop interiors, and buildings).

## Other Tax Provisions

### District of Columbia Enterprise Zone

The District of Columbia (DC) Enterprise Zone includes the DC Enterprise Community and the census tracts in the District of Columbia with a poverty rate of at least 20%. Businesses in the DC Zone are eligible for the following tax benefits: (1) a wage credit equal to 20% of the first \$15,000 in annual wages paid to qualified employees who resided within the District of Columbia; (2) \$35,000 in increased Section 179 expensing; and (3) in certain circumstances, tax-exempt bond financing. Additionally, a capital gains exclusion is allowed for certain investments in small business stock held more than five years and made within the DC Zone, or within any District of Columbia census tract with a poverty rate of at least 10%.<sup>30</sup> The DC Zone incentives, created in the Taxpayer Relief Act of 1997 (P.L. 105-34), were applicable from January 1, 1998 through December 31, 2003, and then extended through December 31, 2005. TRHCA extended the provisions through December 31, 2007.

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

In general, federal excise taxes do not apply to items produced and consumed in Puerto Rico, the U.S. Virgin Islands (USVI), and other U.S. possessions. However, so that goods produced in the possessions do not have a tax-induced price advantage in U.S. markets over goods produced in the mainland, an “equalization tax” is levied on goods imported into the United States from Puerto Rico or the USVI. The tax is equal to the excise tax that applies to like items of domestic manufacture. That tax is then rebated or “covered over” to the Puerto Rico and USVI. The amounts covered over to Puerto Rico and the USVI are deposited into the treasuries of the two possessions for use as those possessions determine. The provision was granted because Congress believed that rebating the increased rate of tax would contribute to the economic stability of Puerto Rico and the USVI.<sup>31</sup>

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

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<sup>30</sup> For more details, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107<sup>th</sup> Cong., 2<sup>nd</sup> sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 317-320.

<sup>31</sup> U.S. House Committee Report to H.R. 3090, H.Rept. 107-251, October 17, 2001.

second extension effective through December 31, 2003. A third extension was authorized by the Working Families Tax Relief Act of 2004, P.L. 108-311, which made the provision effective through December 31, 2005.

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

## **Parity in the Application of Certain Limits to Mental Health Benefits**

The Taxpayer Relief Act of 1997 (P.L. 105-34) imposed an excise tax on group health plans that fail to meet the requirements of the Mental Health Parity Act of 1996 (Title VII of P.L. 104-204). The Mental Health Parity Act requires group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not also imposed on substantially all medical and surgical benefits.<sup>32</sup>

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

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

The Mental Health Parity Reauthorization of 2003, P.L. 108-197, was introduced (S. 1929) and passed in the Senate in November 2003. After being passed in the House on December 8, 2003 the bill was signed into law on December 19, 2003. The legislation extends the mental health parity provisions through 2004 but did not address the extension of the Internal Revenue Code containing the excise tax penalty provision. TRHCA retroactively extended the excise tax through December 31, 2007.

## **Penalty-Free Withdrawals from Retirement Plans for Individuals Called to Active Duty**

Distributions from qualified retirement plans received by participants who have not yet reached the age of 59½ are considered early withdrawals and are subject to

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<sup>32</sup> For more detailed information see CRS Report RL33820, *The Mental Health Parity Act: A Legislative History*, by Ramya Sundararaman and C. Stephen Redhead.



a penalty tax of 10%.<sup>33</sup> Military reservists and national guardsmen called to active duty for an indefinite period or a period in excess of 179 days may make early withdrawals from an IRA, 401(k) plans, 403(b) annuities, and certain similar arrangements, without having to pay the 10% penalty tax. These withdrawals must be made during the period beginning on the date of the call and ending at the close of the active duty period. This provision is available to individuals called to active duty after September 11, 2001, and before December 31, 2007.

An individual who receives a qualified reservist distribution may repay the amount of the distribution, through one or more contributions, at any time during the two-year period beginning on the day after the end of the active duty period. The dollar limitations that are usually applicable to contributions to individual retirement plans are waived in this circumstance. However, no deduction is allowed for any contribution under this provision.

The Pension Protection Act of 2006 (P.L. 109-280) created this temporary tax provision. Legislation has been introduced in the 110<sup>th</sup> Congress which would make the provision permanent (H.R. 867, Guardsmen & Reservists' Tax Fairness Act of 2007). H.R. 2355, the Reservists and Guardsmen Tax Relief Act of 2007, proposes to extend the provision for an additional year, up to and including December 31, 2008. S. 1636 would permanently allow penalty-free withdrawals from retirement plans for individuals called to active duty for at least 179 days.

The Heroes Earnings Assistance and Relief Tax Act of 2008 (H.R. 6081 became P.L. 110-245 in June 2008) made the provision permanent.

## **Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes**

The Pension Protection Act of 2006 (P.L. 109-280) amended the Internal Revenue Code to allow certain individual retirement account (IRA) holders to exclude from gross income up to \$100,000 in qualified distributions from these accounts for charitable purposes. Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½. This provision, which applies to both traditional and Roth IRAs, is scheduled to expire at the end of 2007.<sup>34</sup>

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in Section 170(b)(1)(A). Examples of these organizations include churches, tax-exempt educational organizations, hospitals, university endowment foundations, and public and private charities.

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<sup>33</sup> Any amount withdrawn prematurely from a qualified retirement account is also subject to regular income taxes.

<sup>34</sup> For more information about IRAs, see CRS Report RL30255, *Individual Retirement Accounts (IRAs): Issues and Proposed Expansion*, by Thomas L. Hungerford and Jane G. Gravelle, CRS Report RL31770, *Individual Retirement Accounts and 401(k) Plans: Early Withdrawals and Required Distributions*, by Patrick Purcell, and CRS Report RS22766, *Qualified Charitable Distributions from Individual Retirement Accounts: A Fact Sheet*, by John J. Topoleski.

## Use of Qualified Mortgage Bonds to Finance Residences for Veterans Without Regard to First-Time Homebuyer Requirement

Veterans who served in the active military and did not receive a dishonorable discharge may receive a loan financed by qualified mortgage bonds issued after December 20, 2006, and before January 1, 2008, without regard to the first-time homebuyer requirement. Generally, qualified mortgage bonds cannot be used to finance a mortgage for a homebuyer who owned interest in a principal residence in the three years preceding the execution of the current mortgage (the “first time homebuyer” requirement). Veterans are eligible for this exception one time only without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty.

Qualified veterans’ mortgage bonds must meet certain requirements in order to be eligible for residence financing. For example, at least 95% of the proceeds from such bonds must be used to provide financing for single-family, owner-occupied residences for veterans. Both the principal and the interest of the bonds must be secured by the general obligation of the state of residence. Except in the case of a qualified rehabilitation or the replacement of a construction period loan or temporary initial financing such as a bridge loan, proceeds may not be used to acquire or replace existing mortgages.

This provision was enacted by the Tax Relief and Health Care Act of 2006 (P.L. 109-432).

The Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245) made the waiver of the first-time home buyer rule permanent.

### Federal Unemployment Tax Act (FUTA) Surtax of 0.2%

The Federal Unemployment Tax Act (FUTA) of 1939 (P.L. 76-379) established a joint state and federal basis for financing unemployment compensation (UC) created in the Social Security Act of 1935 (P.L. 74-271). FUTA imposes a 6.2% gross tax rate on the first \$7,000 paid annually by covered employers to each employee in covered positions.

Employers in states with UC programs approved by the federal government and no delinquent federal loans to their state Unemployment Trust Fund (UTF) account may credit 5.4 percentage points against the 6.2% tax rate, making the minimum net federal unemployment tax rate 0.8%. Since all states have approved programs, 0.8% is the effective federal tax rate. This federal revenue finances administration of the system, half of the Federal-State Extended Benefits (EB) Program, and a federal account for state loans. The individual states finance regular UC benefits, as well as half of the EB Program through state taxes authorized by the State Unemployment Tax Acts.<sup>35</sup>

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<sup>35</sup> For more detailed information see CRS Report RL33362, *Unemployment Insurance*: (continued...)

As part of the Unemployment Compensation Amendments of 1976 (P.L. 94-566), Congress passed a surtax of 0.2% of taxable wages to be added to the permanent FUTA tax rate. Thus, the current effective 0.8% FUTA tax rate has two components: a permanent tax rate of 0.6%, and a surtax rate of 0.2%. The surtax was introduced to help repay loans to the states from the federal account in UTF. Congress has extended the surtax five times, most recently with the Taxpayer Relief Act of 1997 (P.L. 105-34), which extends the tax through December 31, 2007.

Except for nonprofit organizations, state and local governments, certain agricultural labor, and certain domestic service, FUTA covers employers who pay wages of at least \$1,500 during any calendar quarter or who employed at least one worker in at least one day of each of 20 weeks in the current or prior year. FUTA does cover agricultural labor for employers who paid cash wages of at least \$20,000 for agricultural labor in any calendar quarter or who employed 10 or more workers in at least one day in each of 20 different weeks in the current or prior year, as well as domestic service employers who paid cash wages of \$1,000 or more for domestic service during any calendar quarter in the current or prior year.

H.R. 6 from the 110<sup>th</sup> Congress, which was signed into law on December 19, 2007 (P.L. 110-140), extends the 0.2% surtax through 2008.

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<sup>35</sup> (...continued)

*Available Unemployment Benefits and Legislative Activity*, by Julie M. Whittaker.