8. PROMOTING TAX FAIRNESS

> *We should cut taxes for the family sending a child to college, for the worker returning to college, for the family saving to buy a home or for long-term health care, and [provide] a $500 per-child credit for middle-income families raising their children. . . . That is the right way to cut taxes—pro-family, pro-education, pro-economic growth.*
>
> President Clinton
> August 29, 1996

The President proposes a tax plan that would promote a fairer tax system and encourage activities that contribute to economic growth—in short, a plan focused on fairness and America's future.

The plan calls for tax cuts that would benefit middle-class families with children, encourage investment in higher education, and promote long-term saving. It would benefit millions of homeowners by ensuring that over 99 percent of home sales are exempt from capital gains taxes. It would provide incentives for employers to hire economically disadvantaged Americans, so they would benefit from wages rather than welfare. It would provide targeted relief to promote economic development and environmental cleanup in distressed areas. It would give estate tax relief to small businesses and farmers. And it would make the tax system more equitable for people with disabilities who are seeking refunds.

The proposal is also fiscally responsible. The budget fully offsets the costs of these tax cuts by making cuts in spending and in unnecessary corporate subsidies and other unwarranted tax breaks.

This chapter provides an overview of the President's tax plan. (See Table 8–1 for a summary of the plan.) Chapter 3 of *Analytical Perspectives* provides further details.

The Middle-Class Tax Cut

The President has long considered tax cuts for middle-income Americans and small businesses a top priority. In 1993, he worked with Congress to cut taxes for 15 million working families by expanding the Earned Income Tax Credit (EITC), and to help small business by increasing "expensing"[1] of investment and capital gains incentives. A year later, he proposed his Middle Class Bill of Rights, including child tax credits, deductions for higher education, and expanded Individual Retirement Accounts. Then in 1996, he signed into law a number of other tax benefits for small businesses and their employees—including even more expensing for small-business investments, greater deductibility of health insurance premiums for the self-employed, and expanded and simplified opportunities for retirement savings. Also in 1996, the President signed into law a $5,000 tax credit for adoption expenses ($6,000 for adopting children with special needs) and higher limits for tax-deductible contributions by spouses to Individual Retirement Accounts.

This year, the budget again proposes the President's Middle Class Bill of Rights. It would immediately and significantly benefit families with young children, encourage investment in post-secondary education and training, and promote long-term saving. This year's tax plan also goes further—it includes more tax incentives and relief with regard to education and training, work opportunities, capital gains on home sales, and the legal limits faced by people with disabilities who seek tax refunds.

Tax Credit for Dependent Children: The budget proposes an income tax credit for each dependent child under age 13, as the President first proposed in 1994. The credit would bene-

[1] That is, up-front deductions.

Table 8–1. THE PRESIDENT'S TAX PLAN
(In billions of dollars)

	Estimate						Total,
	1997	1998	1999	2000	2001	2002	1998–2002
Provide tax relief:							
Middle Class Bill of Rights:							
Tax credit for dependent children	–0.7	–9.9	–6.8	–8.6	–10.4	–10.4	–46.0
Expand individual retirement accounts	....	–1.5	–0.5	–0.8	–1.2	–1.7	–5.5
Incentives for education and training	–0.1	–4.0	–6.2	–7.8	–8.6	–9.4	–36.1
Subtotal, Middle Class Bill of Rights	**–0.8**	**–15.4**	**–13.5**	**–17.2**	**–20.2**	**–21.4**	**–87.6**
Additional targeted tax relief:							
Capital gains exclusion on sale of principal residence	–0.1	–0.3	–0.3	–0.3	–0.3	–0.2	–1.4
Extend the work opportunity tax credit for one year	....	–0.1	–0.2	–0.1	–*	–*	–0.4
Targeted welfare-to-work tax credit	....	–0.1	–0.1	–0.2	–0.1	–0.1	–0.6
Tax incentives for distressed areas	–*	–0.4	–0.5	–0.5	–0.5	–0.4	–2.3
Tax credit for investment in community development institutions and venture capital funds	....	–*	–*	–*	–*	–*	–*
Extend the R&E tax credit for one year	–0.4	–0.8	–0.5	–0.2	–0.1	–*	–1.7
Extend the orphan drug credit for one year	–*	–*	–*	–*	–*	–*	–*
Extend the income exclusion for employer-provided educational assistance through 2000	–0.1	–0.6	–0.7	–0.8	–0.2	....	–2.3
Extend and modify credit for corporations in U.S. possessions	....	–*	–0.1	–0.1	–0.1	–0.1	–0.4
District of Columbia tax incentive	....	–*	–*	–0.1	–0.1	–0.1	–0.3
Estate tax relief for small business	....	–*	–0.2	–0.2	–0.2	–0.2	–0.7
Equitable tolling	....	....	....	....	–*	–*	–0.1
Tax benefits to Foreign Sales Corporations for software licenses	–*	–0.1	–0.1	–0.1	–0.1	–0.1	–0.6
Extend the deduction for contributions of appreciated stock to private foundations for one year	....	–*	–*	....	....	....	–0.1
Total, Provide tax relief	**–1.4**	**–17.9**	**–16.2**	**–19.6**	**–21.9**	**–22.8**	**–98.4**
Eliminate unwarranted benefits	**0.6**	**4.1**	**6.3**	**7.3**	**7.6**	**8.9**	**34.3**
Other changes affecting receipts	....	**1.0**	**1.1**	**1.1**	**1.2**	**1.1**	**5.5**
Extension of expired excise tax provisions	**2.4**	**5.8**	**7.5**	**7.5**	**7.7**	**7.8**	**36.2**
Total proposals	**1.6**	**–7.0**	**–1.4**	**–3.7**	**–5.5**	**–4.9**	**–22.4**

*Less than $50 million.

fit about 18 million families with 34 million dependent children. It would be phased in, starting at $300 per child in tax years 1997 through 1999, and rising to $500 in 2000 and beyond. It would be phased out for taxpayers with adjusted gross incomes between $60,000 and $75,000. Starting in the year 2001, the credit and the phase-out range would be indexed for inflation. The credit would be non-refundable, but working families would first deduct the child credit from their income taxes before deducting the refundable EITC—making it easier for them to get the benefit of both credits.

This tax cut would benefit middle-income families; they have not enjoyed large gains in their incomes over the past 25 years. For a two-parent, two-child family with $50,000 of income and $12,500 of itemized deductions, the credit would cut taxes by 25 percent when fully in place in 2000. In total, the credit would lower families' taxes by $46 billion from 1998 to 2002.

HOPE Scholarships and the Education and Job Training Tax Deduction: The President believes that the tax system should better encourage investment in college education and job training. Therefore, the budget proposes:

- HOPE scholarships, which are tuition tax credits of up to $1,500 per year, available for the first two years of post-secondary education. To receive the credit in the second year, the student must maintain at least a B average. The $1,500 amount (for each of two years) is a per student cap.[2] HOPE scholarships are modeled after a successful program in Georgia.
- The education and job training deduction, which would be available to families for tuition and fees for any college, graduate school, or qualified lifelong learning program. The deduction, which the President first proposed in 1994, would phase up from an annual cap of $5,000 per family in 1997 and 1998 to $10,000 in 1999 and beyond. It would cover tuition at any education or training program that is at least half-time or related to a worker's career. Students who use the HOPE scholarships in their first two years of schooling could claim the tax deduction in their remaining years of qualified education or training (although families could not claim both the credit and the deduction for the same student at the same time).

Both the credit and the deduction would be phased out for joint filers with incomes between $80,000 and $100,000. For single filers, the benefits would phase out between $50,000 and $70,000. From 1998 through 2002, these two provisions would save taxpayers $36.1 billion.

Expanded Individual Retirement Accounts (IRAs): The budget also repeats another proposal from 1994—to expand IRAs to provide greater incentives for long-term savings for retirement and other important purposes. Currently, for taxpayers who participate in employer-sponsored retirement plans and file joint returns, the tax code phases out the availability of deductible IRAs between $40,000 and $50,000 of adjusted gross income. The President's plan would double this range over time, to $80,000 and $100,000, and double the range for single taxpayers to between $50,000 and $70,000. The plan also would index for inflation both of these limits and the current maximum contribution of $2,000.

In addition, the budget proposes that eligible taxpayers be able to contribute to a "Special IRA" as an alternative to a deductible IRA. Contributions to Special IRAs would not be tax deductible, but distributions of the contributions would be tax-free. If contributors kept their funds in the account for at least five years, earnings on the contributions would be available tax-free, too. Many taxpayers would be eligible to convert deductible IRAs to Special IRAs. Also, contributors to both types of IRAs could, under this proposal, withdraw funds without penalty at any time to pay for higher education, first-time home purchases, or expenses during a long period of unemployment.

The greater availability of IRAs would enable many two-earner families to cut their taxes by up to $1,120 a year, if they make the maximum allowable IRA contributions. From 1998 to 2002, it would cut taxes by an estimated $5.5 billion.

Additional Targeted Tax Incentives and Relief

Targeted Homeownership Tax Cut: The budget proposes to allow married taxpayers to exclude from capital gains taxes up to $500,000 in gains from selling a home; single taxpayers could exclude up to $250,000. The exclusion would replace both the one-time exclusion of $125,000, now available for taxpayers over age 55, and the deferral of capital gains, now available when purchasing a more expensive home.

This change would exempt over 99 percent of home sales from capital gains taxes, and dramatically simplify taxes and record-keeping for over 60 million homeowners. It would benefit, in particular, older Americans moving to smaller homes and families moving to lower-cost areas. Taxpayers could use the exclusion every two years.

Work Opportunity Tax Credit: The President wants to replace welfare with work, and to promote the hiring of the economically disadvantaged. The President and Congress last year enacted the Work Opportunity Tax Credit

[2] The budget also would increase Pell Grant college scholarships for low-income families who lack the tax liability to benefit from the tax cuts.

(WOTC) to replace the Targeted Jobs Tax Credit. Employers can claim a tax credit of 35 percent of the first $6,000 that they pay to members of target groups during their first year of employment.

In August, the President also unveiled a Welfare-to-Work initiative, with two proposals that would build on the WOTC:

- A new Welfare-to-Work Credit, targeted to long-term welfare recipients. It would let employers claim a 50-percent credit on the first $10,000 of annual wages that they pay to long-term welfare recipients for up to two years. It would treat education and training, health care, and dependent care benefits as wages eligible for the credit.
- An expansion of the WOTC to include able-bodied childless adults aged 18 to 50 who, under the Administration's Food Stamp proposal, would face a more rigorous work requirement in order to continue receiving Food Stamps.

Tax Incentives to Boost Investment in Distressed Areas: The budget proposes a three-part strategy to increase investment in disadvantaged areas:

- *Expanded Empowerment Zones (EZs) and Enterprise Communities (ECs):* The budget proposes a second round of competition to designate additional EZs and ECs and provides over $1 billion in tax incentives to these areas through 2002. Among other things, the plan would create 20 new EZs and 80 new ECs. The plan promises to mobilize communities to promote business development and create jobs. (For more information on EZs and ECs, see Chapter 6.)
- *Brownfields Cleanup:* The budget proposes to allow businesses to deduct, in the year incurred, certain costs associated with cleaning up "brownfields"—contaminated, and often abandoned, industrial sites—in economically distressed urban and rural areas. (For more information on brownfields, see Chapter 3.)
- *Community Development Financial Institution (CDFI) Tax Credits:* The budget proposes non-refundable tax credits for equity investments in qualified CDFIs. (For more information on CDFIs, see Chapter 6.)

Research and Experimentation Tax Credit (R&E): The budget proposes to extend the R&E tax credit for one year, from its current expiration date of May 31, 1997 to May 31, 1998.[3] It provides a credit against 20 percent of a business's qualified research spending above a base level. Research and experimentation contribute greatly to the Nation's growth in productivity, and the private sector may under-invest in this activity in the absence of this Federal incentive.

Employer-Provided Education: The budget proposes to extend, through December 31, 2000, the income exclusion for employer-provided educational assistance that Congress recently extended through mid-1997, and to expand the exclusion to cover graduate education. The exclusion enables employees to get additional forms of training and education benefits without facing income taxes on those benefits. Small businesses also would be able to claim a 10-percent tax credit for providing such benefits to their employees.

Economic Incentives for U.S. Businesses in Puerto Rico: The budget proposes to modify Section 936 of the tax code, which allows U.S. companies to claim a credit against the tax they pay for income that they derive in Puerto Rico—specifically, to extend the availability of the economic activity credit and to allow new firms to claim it.

Estate Tax Benefits for Closely Held Businesses: The budget proposes to ease the burden of estate taxes on farms and other small businesses, allowing their owners to defer taxes on $2.5 million of value, up from $1 million under current law. The deferred taxes could be paid over 14 years, at a favorable interest rate. In addition, the budget would expand the types of businesses eligible for such treatment by making the form of business organization irrelevant. It also would cut the administrative burden on taxpayers who elected deferral.

[3] The credit, which was first enacted in 1981, expired in mid-1995. The Small Business Job Protection Act of 1996, however, reinstated the credit for the period from July 1, 1996 to May 31, 1997.

Equitable Tolling: The budget proposes to extend the period during which taxpayers with serious disabilities can file claims for refunds, helping to ensure that such taxpayers are not unfairly disadvantaged by the tax system.

Unwarranted Benefits and Other Measures

The budget eliminates or shrinks a wide range of tax loopholes and preferences that are no longer warranted. Some involve highly specialized financial and accounting techniques. Restricting them would help balance the budget, increase the equity and efficiency of the tax system, and keep corporations focused on productivity and profits, rather than on tax minimization.

For example, the plan:

- Prevents certain tax-motivated financial manipulations, used to avoid capital gains taxes.
- Clarifies the treatment of new financial instruments that aim to exploit the different tax treatment of equity and debt, by denying or deferring interest deductions on certain instruments that have substantial equity features.
- Limits the ability of some corporations to deduct the cost of interest associated with purchasing tax-exempt debt.
- Increases the penalty for substantial understatement of taxes, to reduce incentives for excessively aggressive tax planning by corporations with tax liabilities of $100 million or more.

Finally, the plan extends the Airport and Airway excise taxes, the Leaking Underground Storage Tank excise tax, and the Hazardous Substance Superfund excise and corporate income taxes, through 2007. The Administration, however, will propose legislation to replace the Airport and Airway excise taxes with fees for services that the Federal Aviation Adminstration provides.