Highlights of the 2003 Jobs and Growth Tax Relief Reconciliation Act: Economic Stimulus or Long-Term Disaster?

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The 2003 Jobs and Growth Tax Relief Reconciliation Act (sometimes referred to as the “JGTRRA” or the “Act”)1 was signed into law by President Bush on May 28, 2003. JGTRRA was passed by Congress largely along party lines, and required a tie-breaking vote in the Senate by Vice President Cheney.2 It has been projected that JGTRRA will cost $350 billion: $330 billion in lost revenue and $20 billion in aid to the states.3 JGTRRA constitutes one of the largest tax cuts in the history of the United States.

This article highlights some of the major provisions of JGTRRA, discusses some of the few planning opportunities offered under the Act, and criticizes the complexity and the fiscal irresponsibility of the Act. JGTRRA accelerates the reduction in the individual income tax rates that were not scheduled to begin until 2006, provides marriage penalty relief, increases the child tax credit, and increases the alternative minimum tax exemption. The Act also reduces the maximum federal tax rate on certain capital gains and dividends and provides temporary aid to the states.

The JGTRRA tax cuts have raised considerable controversy. Proponents of “supply side” economics have argued that the tax cuts will create economic and job growth.4 On the other hand, JGTRRA has been highly criticized because it adds to an already burgeoning federal deficit that may cause economic problems for generations to come and because of its complexity.5 The Act contains a number of sunset provisions that, in combination with the sunset and delayed effective

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3. Id.
4. "Supply side economics" is a term used to refer to an economic theory which posits that creating demand through tax cuts will spur the economy. For some of the argument made on both sides of the debate concerning the JGTRRA tax cuts, see Richard W. Stevenson, Bush Signs Tax Cut Bill, Dismissing All Criticism, N.Y. Times (May 29, 2003), at A18.
dates of the provisions of the Economic Growth and Tax Relief and Reconciliation Act of 2001 ("EGTRRA"), create confusion and raise difficulties for tax planners.

Part I of this article discusses the major provisions of JGTRRA and some of the planning opportunities and tax traps that may be available under the Act. Part II criticizes the Act and suggests a repeal of many of its provisions.

I. HIGHLIGHTS OF THE ACT

A. Reduction in the Individual Income Tax Rates on Ordinary Income

JGTRRA reduces the four top marginal individual income tax rates and expands the two lower tax brackets. The Act also reduces the tax rates for married couples in such a way as to eliminate the marriage penalty created by the differential between the tax rates on income of unmarried taxpayers and the rates on income of married couples for 2003 and 2004. Thereafter, the discrepancy is reduced, but not eliminated, for 2005, 2006, and 2007, and then eliminated from 2008 until 2010.

To better understand the effect of the rate reductions under JGTRRA, it is useful to review the changes in the individual marginal income tax rates made by EGTRRA. Under federal income tax law, individuals pay taxes at progressively higher rates on increasing increments of an individual's taxable income. For example, Section 1(a) of the Internal Revenue Code provides that the taxable income of a married couple filing a joint return or a surviving spouse is taxed according to the following table:

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $36,900</td>
<td>15% of taxable income</td>
</tr>
<tr>
<td>Over $36,900 but not over $89,150</td>
<td>$5,535, plus 28% of the excess over $36,900</td>
</tr>
<tr>
<td>Over $89,150 but not over $140,000</td>
<td>$20,165, plus 31% of the excess over $89,150</td>
</tr>
<tr>
<td>Over $140,000 but not over $250,000</td>
<td>$35,928.50, plus 36% of the excess over $140,000</td>
</tr>
<tr>
<td>Over $250,000</td>
<td>$75,528.50, plus 39.6% of the excess over $250,000</td>
</tr>
</tbody>
</table>

9. I.R.C. § 1(a) (2003), amended by the Omnibus Budget Reconciliation Act
The tables provided in Section 1(a) through (e) reflect the individual income rates that were effective from 1993\(^\text{10}\) until 2001 when they were changed by EGTRRA.\(^\text{11}\) Section 1 performs the calculations of tax on the increments of income (sometimes referred to as "brackets") that precede the taxpayer's highest bracket. For example, $5,535 is 15% of $36,900, and $20,165 is 15% of $36,900, plus 28% of $52,250 (the difference between $89,150 and $36,900). The amount of income in each of the tax brackets is adjusted annually for inflation\(^\text{12}\) and varies depending on the filing status of the taxpayer.\(^\text{13}\)

EGTRRA gradually reduced the individual tax rates and added a 10% bracket.\(^\text{14}\) The 1993 individual income tax rates for each of the brackets were 15%, 28%, 31%, 36%, and 39.6%. Under EGTRRA, these rates were scheduled to be reduced to: (1) 10%, 15%, 27%, 30%, 35%, and 38.6% for 2003; (2) 10%, 15%, 26%, 29%, 34%, and 37.6% for 2004 and 2005; and (3) 10%, 15%, 25%, 28%, 33%, and 35% for 2006 through 2010.\(^\text{15}\) JGTRRA provides that the tax rates that were scheduled to apply in 2006 are effective for an individual's taxable income in 2003 and thereafter.\(^\text{16}\)

All the provisions, including the reductions in the individual income tax rates under both EGTRRA and JGTRRA, will expire after December 31, 2010.\(^\text{17}\) At that time, unless Congress decides otherwise, the 1993 individual income tax rates will become effective again.

The accelerated reduction in the individual income tax rates is unlikely to affect tax planning for most taxpayers, at least until 2010, the year before the 1993 tax rates will become effective. Taxpayers may seek to accelerate taxable income to 2010 when the tax rates are low in order to avoid the higher rates on such income that will apply

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\(^{13}\) There are five categories of filing status: (1) married filing jointly or a surviving spouse; (2) head of household; (3) unmarried; (4) married filing a separate return; and (5) trust or estate. I.R.C. § 1(a)-(e) (2003).


in 2011 when JGTRRA expires. A taxpayer who uses the cash method of reporting income may be able to accelerate income by collecting amounts of income, such as fees for services, in 2010 that otherwise may not be paid until 2011.\textsuperscript{18} Alternatively, such a taxpayer may accelerate taxable income by delaying the payment of deductible expenses until 2011 where those expenses otherwise would be payable in 2010.\textsuperscript{19} Of course, a taxpayer may accelerate even more income by accelerating receipts and delaying payments where possible. Taxpayers who are skeptical that Congress will leave the low income tax rates in place until 2010 may want to accelerate as much taxable income as possible to 2004 when they know that the rates are settled. However, the time value of money may cause deferral of income to result in better after-tax economic results than acceleration of income, even if the income will be taxed at a higher rate in a later year.\textsuperscript{20}

\textbf{B. Marriage Penalty Relief}

For a long time, the federal income tax has contained a number of provisions that create marriage penalties and marriage bonuses. EGTRRA and JGTRRA provide marriage penalty relief for married couples with taxable income in the 10- and 15\% income tax brackets and for married couples who claim the standard deduction, rather than itemized deductions.\textsuperscript{21}

\begin{itemize}
\item \textsuperscript{18} Most individuals are cash-method taxpayers. Under the cash method of reporting income, a taxpayer generally includes an item in income in the taxable year in which the item is actually or constructively received by the taxpayer. Treas. Reg. \textsection 1.451-1(a) (2004). An item of income is constructively received in the taxable year in which the item is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available to the taxpayer so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice and intention to withdraw had been given. Treas. Reg. \textsection 1.451-2(a) (2004).
\item \textsuperscript{19} Under the cash method of accounting, a taxpayer may deduct an item in the taxable year in which the item is paid. Treas. Reg. \textsection 1.461-1(a)(1) (2004).
\item \textsuperscript{20} The phrase "time value of money" is used to described the fact that a dollar received in the current year is worth more than a dollar received sometime in the future. C. Steven Bradford & Gary Adna Ames, Basic Accounting Principles for Lawyers 109 (Anderson Publishing Co. 1997). In other words, if a taxpayer pays $100 less in federal taxes in 2004 because the taxpayer can defer the amount of income that would be taxed at $100, and the taxpayer is required to pay the tax liability in 2011, the taxpayer may invest the $100 of tax savings in 2004 and the return on the investment may be large enough to more than offset the additional tax that is required to be paid on the income in 2011.
\item \textsuperscript{21} Marriage penalties and bonuses are provided in many of the income tax statutes besides the rate structure and the standard deduction. A discussion of each of the penalties and bonuses is beyond the scope of this article. For a discussion of
The term "marriage penalty" refers to the larger amount of tax generally imposed on the income of married couples in cases where both spouses have income, as compared to the income tax liability of two unmarried taxpayers with the same amount of income. The term "marriage bonus" refers to the smaller amount of tax imposed on the income of a one-earner married couple, as compared to the amount of tax imposed on the same amount of income earned by an unmarried taxpayer.

Section 1(a), which provides the 1993 federal income tax rates on the income of a married couple, was provided earlier. Section 1(c) provides the following rate table for determining the federal income tax liability of an unmarried taxpayer:

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $22,100</td>
<td>15% of taxable income.</td>
</tr>
<tr>
<td>Over $22,100 but not over $53,500</td>
<td>$3,315, plus 28% of the excess over $22,100.</td>
</tr>
<tr>
<td>Over $53,500 but not over $115,000</td>
<td>$12,107, plus 31% of the excess over $53,500.</td>
</tr>
<tr>
<td>Over $115,000 but not over $250,000</td>
<td>$31,172 plus 36% of the excess over $115,000.</td>
</tr>
<tr>
<td>Over $250,000</td>
<td>$79,772, plus 39.6% of the excess over $250,000.</td>
</tr>
</tbody>
</table>

Prior to the enactment of JGTRRA, the standard deduction also included a marriage penalty. Each year, an individual generally may elect either to claim the standard deduction or else to claim itemized deductions, such as the deductions for home loan mortgage interest; investment interest; state, local, and foreign property taxes; state, local, and foreign income taxes; personal casualty and theft losses; charitable contributions; and medical expenses. A taxpayer

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20. Supra note 9 and accompanying text.
generally will claim the standard deduction if the taxpayer’s standard
deduction is greater than the total amount of the taxpayer’s itemized
deductions.\textsuperscript{32}

Before EGTRRA was enacted, Section 63 provided that the
standard deduction for married taxpayers filing joint returns and for
surviving spouses was $5,000, and for unmarried taxpayers, the
standard deduction was $3,000.\textsuperscript{33} In computing taxable income, a
taxpayer generally is permitted to deduct an exemption amount for the
taxpayer and each of the taxpayer’s dependents.\textsuperscript{34} Section 151 provides
that the exemption amount generally is $2,000.\textsuperscript{35} The $2,000 amount
is adjusted annually for inflation.\textsuperscript{36} The following examples illustrate
the effect of marriage penalties and bonuses under the rate structure
provided in Section 1(a) and (c) of the Internal Revenue Code, the basic
standard deduction amounts provided in Section 63(c), and the $2,000
allowance for each personal exemption provided in Section 151,
without adjustments for inflation.

\textbf{Example #1:} Alice and Bob are a married couple who have no
Alice and Bob each have $35,000 of adjusted gross income in
1993. The income tax liability reported on their joint income
tax return is computed as follows:

\begin{align*}
\text{Combined Adjusted Gross Income} & \quad \text{\ldots} \quad \$70,000 \\
\text{Less, the Standard Deduction} & \quad \text{\ldots} \quad \$5,000 \\
\end{align*}

\textsuperscript{32} Certain taxpayers are not permitted to claim the standard deduction. Such
taxpayers include a married individual filing a separate return where either spouse
itemizes deductions, a nonresident alien individual, an individual making a return
under Section 443(a)(1) for a period of less than 12 months on account of a change
in the taxpayer’s annual accounting period, and an estate or trust, common trust

amounts in the text sometimes are referred to as the “basic” standard deduction.
Certain taxpayers are entitled to claim a larger standard deduction than $5,000 or
$3,000. In the case of a taxpayer who is over the age of 65 and/or blind, Section
63 adds to the basic standard deduction amounts provided above $600 for each
characteristic. I.R.C. § 63(f)(1), (2) (2003). In the case of an individual who was
not married and not a surviving spouse, this “additional standard deduction” is
$750. I.R.C. § 63(f)(3) (2003). Both the basic standard deduction and the
additional standard deduction are adjusted annually for inflation. I.R.C. § 63(c)(4)
(2003). Because EGTRRA and JGTRRA did not affect the amount of the
additional standard deduction, there is no reference to the additional standard
deduction in the text.

\textsuperscript{34} I.R.C. § 151(a), (c) (2003).

\textsuperscript{35} I.R.C. § 151(d)(1) (2003). The total amount of deductions for exemptions
that otherwise would be allowable under Section 151 is phased out for certain high-

\textsuperscript{36} I.R.C. § 151(d)(4) (2003).
Less, Two Exemption Amounts ............ ($6,000)
Taxable Income ....................... $59,000
Tax under § 1(a) ...................... $11,72337

Alice and Bob would incur the same tax liability if only one of the spouses had $70,000 of adjusted gross income.

If Alice and Bob were unmarried roommates, it is likely that they would incur the same living expenses as they would if they were married. However, in such a case their combined federal income tax liability would differ, depending on whether each individual had adjusted gross income of $35,000 or whether only one person had adjusted gross income of $70,000.

Example #2: Assume that Alice and Bob are unmarried and each individual has adjusted gross income of $35,000. The federal income tax liability of each individual would be computed as follows:

Adjusted Gross Income ............... $35,000
Less the Standard Deduction .......... ($3,000)
Less One Exemption Amount .......... ($2,000)
Taxable Income ....................... $30,000
Federal Income Tax Liability ........... $5,52738

Under these facts, the combined tax liability of Alice and Bob is $11,054 if they are unmarried ($5,527 X 2). The marriage penalty is $669, the additional amount of income tax ($11,723 – $11,054) that the couple must pay if they are married. However, the couple would enjoy a marriage bonus if only one of the taxpayers had adjusted gross income of $70,000.

Example #3: Assume that Alice has adjusted gross income of $70,000 and Bob has no adjusted gross income and that Alice and Bob are not married and not members of the same family. Because they are not married, Alice may not be permitted to claim an exemption amount for Bob even though

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37. The $11,723 tax liability is computed by reference to Section 1(a) as $5,535 (15% of $36,900,) plus $6,188 (28% of ($59,000–$36,900).
38. Each individual's $5,527 tax liability is computed by reference to the table in Section (c), as $3,315 (15% of $22,100), plus $2,212 (28% of $7,900 ($30,000–$22,100)).
she supports him. Alice’s tax liability is computed as follows:

- **Adjusted Gross Income**: $70,000
- **Less the Standard Deduction**: ($3,000)
- **Less, One Exemption Amount**: ($2,000)

**Taxable Income**: $65,000

**Federal Income Tax Liability**: $15,672

The facts in Example #3 illustrate a marriage bonus of $3,949, the amount by which Alice’s federal income tax liability of $15,672 exceeds the $11,723 amount of tax that the couple would owe if they were married and filed a joint income tax return. Under EGTRRA, the amount of income in the 10% bracket for unmarried taxpayers and married taxpayers filing separate returns for 2003 through 2007 was $6,000 and for married taxpayers filing a joint return and surviving spouses was $12,000. In 2008, 2009, and 2010, EGTRRA increased

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39. Under I.R.C. § 151(c), a taxpayer may claim an exemption amount for each dependent whose gross income for the taxable year is less than the exemption amount. For this purpose, the term "dependent" is defined to include members of the taxpayer’s family and an individual who for the taxable year has as his or her principal place of abode the taxpayer’s home and is a member of the individual’s household. I.R.C. § 152(a) (2003). While Bob may have Alice’s home as his principal place of abode and may be a member of Alice’s household for the tax year, Alice still may not be entitled to claim Bob as a dependent if at any time during the taxable year, Alice’s relationship with Bob is in violation of local law. I.R.C. § 152(b)(5) (2003). An unmarried taxpayer who lives with and supports another unmarried individual often is not permitted to claim that individual as a dependent under this rule. See, e.g., Ensminger v. Commissioner, 610 F.2d 189 (4th Cir. 1979) (dependency exemption disallowed to unmarried taxpayer living with and supporting a 21-year-old woman because North Carolina statute made lewd and lascivious cohabitation a misdemeanor); Estate of Daniel Buckley, 37 T.C. 664 (1962) (no dependency exemption allowed where purported marriage of the taxpayer was determined to be invalid under applicable local law); Leonard J. Eichbauer v. Comm’r, 30 T.C.M. (CCH) 581 (1971) (taxpayer denied dependency exemption for woman with whom he was cohabiting and whom he supported because the taxpayer failed to prove that their relationship was not in violation of local law). But see Shackelford v. United States, 3 B.R. 42 (Bankr. W.D. Mo. 1980) (dependency exemption allowed to taxpayer unmarried woman who was living with and supporting an unmarried man because there was nothing illegal about the couple living together in a sexual relationship in Missouri so long as adultery and gross lewdness statute was not violated).

40. Alice’s $15,672 income tax liability is determined by reference to the table in Section 1(c) as $12,107 ($3,315 (15% of $22,100), plus $8,792 (28% of $31,400 ($53,500 - $22,100)), plus $3,565 (31% of $11,500 ($65,000 - $53,500))).

the amounts in the 10% bracket to $7,000 and $14,000, respectively.\textsuperscript{42} JGTRRA provides that the amounts of income in the 10% bracket are: (1) $7,000 and $14,000, respectively for 2003 and 2004; (2) $6,000 and $12,000 for 2005, 2006, and 2007; and (3) $7,000 and $14,000 for 2008, 2009, and 2010.\textsuperscript{43}

EGTRRA also gradually increased the amount of income in the 15% bracket for married taxpayers from 2005 through 2010 so that in 2008, 2009, and 2010, the amount of income in the 15% bracket for married taxpayers filing a joint return and surviving spouses will be twice the amount of income in the 15% bracket for unmarried taxpayers and the amount of income in the 15% bracket for married taxpayers filing separate returns was the same as the amount of income in the 15% bracket for unmarried taxpayers.\textsuperscript{44} JGTRRA accelerates the marriage penalty relief by increasing the amount of income in the 15% bracket for married couples filing a joint return and surviving spouses in 2003 and 2004 to twice the amount in the 15% bracket for unmarried taxpayers.\textsuperscript{45} JGTRRA also increases the amount of income in the 15% bracket for married taxpayers filing separate returns so that it is the equal to the amount in the 15% bracket for unmarried taxpayers.\textsuperscript{46} For 2005, 2006, and 2007, JGTRRA retains the gradual schedule of increased amounts of income in the 15% bracket for married taxpayers that had been enacted by EGTRRA.\textsuperscript{47}

JGTRRA also accelerates the marriage penalty relief that had been provided under EGTRRA with respect to the amount of the standard

\begin{center}

\begin{tabular}{|l|c|}
\hline
For taxable years beginning & The applicable percentage is:
\hline
in calendar year: & \\
2003 and 2004 & 200 \\
2005 & 180 \\
2007 & 193 \\
2008, 2009, and 2010 & 200 \\
\hline
\end{tabular}

\end{center}

deduction. Under EGTRRA, the standard deduction for married taxpayers and surviving spouses remained the same (as adjusted for inflation) until 2005. From 2005 until 2010, EGTRRA gradually increased the amount of the standard deduction for married taxpayers filing a joint return and surviving spouses. The schedule for increasing the standard deduction for married taxpayers and surviving spouses under EGTRRA provided that in 2009 and 2010, the standard deduction would equal twice the standard deduction for an unmarried individual. EGTRRA also gradually increased the standard deduction for a married taxpayer filing a separate return so that in 2009 and 2010, the standard deduction for such filers was equal to the basic standard deduction for unmarried taxpayers. JGTRRA retains EGTRRA's phased-in schedule for increasing the standard deduction for married taxpayers and surviving spouses for 2005–2010 but also increases the standard deduction for such taxpayers in 2003 and 2004 to twice the amount allowed for unmarried taxpayers and provides that married taxpayers filing separate returns may use the same standard deduction as unmarried taxpayers for 2003 and 2004. The following examples, using the JGTRRA rate tables, the standard deduction, and the exemption amount, as adjusted for inflation, illustrate the effect of the marriage penalty relief under JGTRRA:

**Example #4:** Assume the same facts as in Example #1, except that the taxable year is 2004. Alice and Bob, a married couple, each have adjusted gross income of $35,000. If they file a joint return, their 2004 federal income tax liability on their combined $70,000 of adjusted gross income is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Gross Income</td>
<td>$70,000</td>
</tr>
<tr>
<td>Less the Standard Deduction</td>
<td>($9,700)</td>
</tr>
<tr>
<td>Less Two Exemption Amounts</td>
<td>($6,200)</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td><strong>$54,100</strong></td>
</tr>
<tr>
<td><strong>Tax Liability</strong></td>
<td><strong>$7,400</strong></td>
</tr>
</tbody>
</table>

49. **Id.**
50. **Id.**
52. The $7,400 federal income tax liability is determined by reference to the tax rates provided in Rev. Proc. 2003–85 § 3.01 Table 1, 2003–49 I.R.B. 1184, the standard deduction provided in Rev. Proc. 2003–85 § 3.10(1), and the exemption amount provided in Rev. Proc. 2003–85 § 3.16(1).
Example #5: Assume the same facts as in Example #2. Alice and Bob are roommates who not married, each of whom has adjusted gross income of $35,000 in 2004. Each individual's federal income tax liability is determined as follows:

Adjusted Gross Income ....................... $35,000
Less the Standard Deduction .................. ($4,850)
Less One Exemption Amount ................... ($3,100)

Taxable Income ............................ $27,050
Tax Liability ............................... $3,700

In Example #5, the total tax liability of the two taxpayers is $7,400 (2 X $3,700). In Example #4, the highest marginal tax rate on the combined income of Alice and Bob is 15%. Similarly, the highest marginal tax rate on the individual incomes of Alice and Bob, as unmarried taxpayers in Example #5, is 15%. Because JGTRRA doubles the amount of income in the 10- and 15% tax brackets and doubles the amount of the standard deduction for married couples, as compared with unmarried individuals, Alice and Bob enjoy the full benefit of the marriage penalty relief under JGTRRA under the facts of Example #4.

JGTRRA, however, significantly increases the marriage bonus. In Example #4, Alice and Bob, as married taxpayers, will have the same $7,400 federal income tax liability, regardless of whether each spouse has $35,000 of adjusted gross income or only one of the spouses has $70,000 of adjusted gross income. In contrast, if Alice and Bob are unmarried roommates, Alice has $70,000 of adjusted gross income, and Bob has no income in 2004, their combined federal income tax liability will be computed as follows:

Adjusted Gross Income ....................... $70,000
Less, Standard Deduction ..................... ($4,850)
Less, One Exemption Amount .................. ($3,100)

Taxable Income ............................ $62,050
Tax Liability ............................... $12,250


54. The $12,250 tax liability is determined by reference to Rev. Proc. 2003–85 § 3.01 Table 3, 2003–49 I.R.B. 1184, as $4,000, plus $8,250 (25% of $33,000...
In this case, the marriage bonus for Bob and Alice is $4,850, the difference between the $12,250 federal income tax that Alice would be required to pay if she were single, and the $7,400 federal income tax that Alice and Bob would have to pay as a married couple. By increasing the marriage bonus, JGTRRA creates inequity in the federal Income Tax Code. A concept referred to as "horizontal equity" demands that similarly situated taxpayers should be taxed similarly. Increasing the marriage bonus violates this principle by increasing the relative tax burden on unmarried taxpayers.

Some might argue that the marriage bonus is desirable because it encourages taxpayers to marry, while the marriage penalty discourages marriage for two-earner couples. However, the effects of the tax laws on decisions to marry are unproven.

To the extent that the marriage penalty actually does deter taxpayers from marrying, it is most likely to affect marital decisions of low-income taxpayers rather than middle-income and high-income taxpayers. Professor Edward McCaffery has suggested that the marriage penalty may deter lower-income taxpayers from marrying, due to the marriage penalty provisions of the earned income credit.

Under the earned income credit provisions, a tax credit of up to $4,300 is available to taxpayers in 2004 with two or more qualifying children (generally children under the age of 19 or children who are students and under the age of 24). The $4,300 amount is phased out for married taxpayers filing joint returns with adjusted gross income of $15,040, and completely phased out for married taxpayers filing joint returns with adjusted gross income of $35,458 or more. No earned income credit is available to married taxpayers who file separate returns. The $4,300 maximum earned income credit is phased out for unmarried taxpayers with adjusted gross income of ($62,050 – $29,050).

57. I.R.C. § 32 (2003). For the maximum amount of the earned income credit available in 2004, see Rev. Proc. 2003–85 § 3.06(1), 2003–49 I.R.B. 1184. For purposes of the earned income credit, the term "qualifying child" generally is defined as: (1) an individual who is a son, daughter, stepdaughter, stepson, or a descendent of any such individual, a brother, sister, stepbrother, stepsister, or a descendent of any such individual, or a foster child of the taxpayer; (2) who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; and (3) has not attained the age of 19 as of the close of the taxable year, is a student and has not attained the age of 19 as of the close of the taxable year, or who is permanently disabled at any time during the taxable year. I.R.C. § 32(c)(3) (2003).
58. Id.
$14,040, and completely phased out for such filers with adjusted gross income of $34,458 or more.\(^{60}\)

Thus, if two individuals each have two qualifying children and adjusted gross income (and earned income) of $14,040 in 2004, each individual taxpayer will be entitled to claim an earned income credit of $4,300, or a total of $8,600 in earned income credits. In contrast, if the two individuals marry, they may only claim an earned income credit with respect to two of their four qualifying children. Moreover, their maximum earned income credit of $4,300 will be phased out, and they will be entitled to claim an earned income credit of $1,554.\(^{61}\)

Thus, by marrying, the couple incurs a marriage penalty of $7,046 ($8,600 allowable earned income credit allowable to two unmarried taxpayers—$1,554 earned income tax credit allowable if they marry). The $7,046 marriage penalty in this case represents 25% of the couple’s combined $28,080 of adjusted gross income. JGTRRA does nothing to reduce the marriage penalty under the earned income credit provisions.

Marriage penalties and bonuses, however, can create a disincentive for one spouse (usually the wife) to work. For example, assume that in Example \#4, Alice earns all of the couple’s $70,000 of adjusted gross income. For 2004, the highest amount of taxable income in the 15% bracket for a married couple filing a joint return is $58,100.\(^{62}\) In Example \#4, the couple had $54,100 of taxable income. If Bob works and earns more than $4,000 of income, every dollar that Bob earns over $4,000 will be taxed at a rate of 25%. The higher rate of tax that would apply to income over $4,000 earned by Bob might deter Bob from working. The additional tax might not make it worth the additional expenses for transportation, clothing, and food that working taxpayers often incur. The disincentive for spouses to work is more pronounced for high-income married couples because there is no marriage penalty relief for married couples with taxable income in brackets higher than 15%. Nevertheless, there is no empirical evidence concerning the effect of the tax laws on spouses’ work-related decisions.

The elimination and reduction of the marriage penalty with respect to the standard deduction may reduce the number of married taxpayers who itemize their deductions. In 2004, the standard deduction for a married couple filing a joint return is $9,700. The


\(^{61}\) Under I.R.C. Sections 32(a)(2) and (b)(1), the maximum earned income credit for taxpayers with 2 or more qualifying children is reduced by $2,746 (the phaseout percentage of 21.06% of $13,040 (the $28,080 (2 X $14,040) amount of adjusted gross income (or, if greater, earned income) in excess of the $15,040 threshold amount)).

\(^{62}\) Rev. Proc. 2003-85 § 3.01 Table 1, 2003-49 I.R.B. 1184.
higher standard deduction for married couples may discourage such taxpayers from making charitable contributions. A taxpayer may deduct charitable contributions only if the taxpayer itemizes deductions.\textsuperscript{63} The most commonly claimed itemized deductions are the deduction for qualified residence interest (home loan mortgage interest) and state income and property taxes.\textsuperscript{64} Taxpayers who live in states that impose small income and property taxes and those who either rent or have paid off the mortgage on their homes are unlikely to claim itemized deductions. For some married taxpayers, the increase in the standard deduction, by eliminating the ability of such taxpayers to take advantage of a deduction for charitable contributions, provides little incentive to make such contributions.

C. Increased Child Tax Credit

JGTRRA increases the amount of the child tax credit that individual taxpayers may claim.\textsuperscript{65} As originally enacted, Section 24 allowed a taxpayer to claim a child tax credit of $500 (for taxable years beginning in 1998) for each of the taxpayer's qualifying children.\textsuperscript{66} EGTRRA gradually increased the amount of the per-child tax credit as follows:

In the case of any taxable year beginning in—

<table>
<thead>
<tr>
<th>Year</th>
<th>Per Child Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$800</td>
</tr>
<tr>
<td>2010</td>
<td>$1,000\textsuperscript{67}</td>
</tr>
</tbody>
</table>

JGTRRA increases the per-child amount of the credit to $1,000 for 2003 and 2004, and then follows the same schedule described above for 2005 through 2010. As explained earlier, all of the provisions under both EGTRRA and JGTRRA expire after 2010. Thus, unless Congress provides otherwise, the amount of the per-child tax credit will be $500 for taxable years beginning in 2011 and thereafter.

\textsuperscript{63} I.R.C. § 67(b)(4) (2003).
For purposes of Section 24, the term "qualifying child" is generally defined as any individual if: (1) the taxpayer is allowed a dependency deduction with respect to the individual; (2) the individual has not attained the age of 17 as of the close of the calendar year in which the taxpayer’s taxable year begins; and (3) the individual is a son, daughter, stepson, or stepdaughter, or a descendent of a son, daughter, stepson, or stepdaughter of the taxpayer; a brother, sister, stepbrother, stepsister or a descendent of any such individual, for whom the taxpayer cares as the taxpayer’s own child; or an eligible foster child, i.e., an individual who is placed with the taxpayer by an authorized placement agency and for whom the taxpayer cares as the taxpayer’s own child. The child tax credit applies, both for purposes of determining a taxpayer’s regular income tax liability and for purposes of determining the taxpayer’s alternative minimum tax liability, if any.

The amount of the child tax credit that otherwise may be claimed in any year is limited for both high-income and low-income taxpayers. Under Section 24(b), the amount of the otherwise allowable child tax credit is reduced (but not below zero) by $50 for each $1,000 (or fraction thereof) by which the taxpayer’s modified adjusted gross income exceeds a threshold amount. For this purpose, the term “modified adjusted gross income” is defined as adjusted gross income, increased by amounts that are excluded from gross income under Sections 911, 931, or 933. In general, Sections 911, 931, and 933 allow individual taxpayers who reside outside the United States to exclude from income certain amounts earned outside the United States.

The threshold amount for phasing out the child tax credit varies, depending on the taxpayer’s filing status. For married taxpayers


71. Id.

72. Section 911 allows a United States citizen who resides and works outside the United States to exclude up to $80,000 of earned income and a housing allowance in computing the taxpayer’s gross income. Section 931 allows a bona fide resident of Guam, American Samoa, or the Northern Mariana Islands to exclude income derived from sources within any of the foregoing U.S. possessions and income effectively connected with the conduct of a trade or business by the individual within any of such U.S. possessions. Under Section 933, an individual who is a bona fide resident of Puerto Rico during the entire taxable year may exclude income derived from Puerto Rican sources (other than amounts for services performed as an employee of the United States or any agency thereof). I.R.C. § 933 (2003).
filing a joint account, the threshold amount is $110,000. The threshold amount is $75,000, in the case of an individual who is not married and $55,000, in the case of an individual who is married and files a separate return. The following example illustrates the application of the phase-out rules for taxpayers with modified adjusted gross income above the threshold amount:

**Example #6:** Assume that Bill and Sally are married, have two qualifying children, and file a joint income tax return. The couple's modified adjusted gross income for 2004 is $140,000. In 2004, Bill and Sally would be entitled to claim a child credit of $2,000 (2 children X $1,000 child tax credit) if their modified adjusted gross income had been $110,000 or less. Under the phase-out formula of Section 24, however, the couple must reduce the $2,000 otherwise allowable child tax credit by $1,500 ($50 X 30 (($140,000 - $110,000)/$1,000)). Thus, Bill and Sally may claim a child tax credit of $500 in 2004 ($2,000 - $1,500).

As the foregoing example illustrates, the child credit for a couple with two children is completely phased out if the couple has $150,000 or more in modified adjusted gross income. If a married couple has $150,000 of modified adjusted gross income and three children, however, the couple may claim a child tax credit of $1,000 ($3,000 otherwise allowable child tax credit, reduced by $2,000 ($50 X 40 (($150,000 - $110,000)/$1,000))).

The availability of the child tax credit is also limited for certain low-income taxpayers. Only a portion of the credit is refundable. Thus, a taxpayer with too little taxable income to absorb the child tax credit may lose the advantage that otherwise would be available. For 2004, the child tax credit is refundable under Section 24(d) to the extent of 10% of the amount by which the taxpayer's earned income exceeds $10,750. Under this formula, a taxpayer or married couple with $10,750 or less of income in 2004 is not eligible for a child tax credit. A taxpayer with one qualifying child and $16,750 of earned income in 2004 would be allowed a child credit of $600 (10% of

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$6,000 (the amount by which $16,750 exceeds $10,750). The amount of the nonrefundable portion of the child tax credit allowed under Section 24(d) reduces the refundable portion allowed under Section 24(a) without regard to the tax liability limitation.\(^7\)

**Example #7:** In 2004, Jack and Jill are married and have two qualifying children and earned income of $25,750. They have no other income. Jack and Jill are entitled to no refundable tax credits other than the child tax credit. Assume that the couple’s tax liability is determined as follows:

\[
\begin{align*}
\text{Adjusted Gross Income} & \quad \ldots \quad $25,750 \\
\text{Less, the Standard Deduction} & \quad \ldots \quad (9,700) \\
\text{Less, Personal Exemptions} & \quad \ldots \quad (12,400) \\
\text{Taxable Income} & \quad \ldots \quad $3,650 \\
\text{Tax on } $3,650 & \quad \ldots \quad $365
\end{align*}
\]

The nonrefundable child tax credit under Section 24(a) is $2,000 ($1000 child tax credit \(\times\) 2 qualifying children). The amount of the refundable credit is $1,500, which is the lesser of: (1) $2,000 (the amount of the credit that would be allowable if the entire credit were refundable without regard to the tax liability limitation) or (2) $1,500 (10% of $15,000 (the amount by which $25,750 exceeds $10,750)). The refundable child tax credit allowed under Section 24(d) ($1,500) reduces the $2,000 nonrefundable child credit without regard to the tax liability limitation. Thus, in this case, Jack and Jill may claim an additional $365 of child tax credit to eliminate their federal income tax liability, and the total child tax credit allowed to Jack and Jill is $1,865.

In the case of a taxpayer with three or more qualifying children, however, Section 24(d) provides that the refundable portion of the child tax credit is the amount (if any) by which the taxpayer’s social security taxes for the year exceed the earned income credit allowable to the taxpayer, if that amount exceeds the otherwise allowable refundable portion of the credit discussed in the foregoing paragraph.\(^9\) For this purpose, the term “social security taxes” generally means the amount of the tax liability due from an

\(^7\) I.R.C. § 24(d)(1) (2003), flush language.

employee with respect to an employee’s wages under the Federal Insurance Contributions Act ("FICA tax") or the Railroad Retirement Tax Act⁸⁰ or one-half of the amount of a self-employed taxpayer’s self employment tax.⁸¹

**Example #8:** Angela and Bill Jones are married and have three qualifying children and earned income (wages) of $31,750 in 2004. The couple has no other income. They are not entitled to any refundable credits other than the child tax credit. Assume that the couple’s 2004 federal income tax liability is computed as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>$31,750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less, the Standard Deduction</td>
<td>($9,700)</td>
</tr>
<tr>
<td>Less, the Personal Exemptions</td>
<td>($15,500)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$6,550</td>
</tr>
<tr>
<td>Tax on $6,550</td>
<td>$655</td>
</tr>
<tr>
<td>Earned Income Credit</td>
<td>$781²²</td>
</tr>
<tr>
<td>FICA Paid (Employee’s Share)</td>
<td>$2,429³³</td>
</tr>
</tbody>
</table>

The nonrefundable child tax credit under Section 24(a) is $3,000 ($1,000 per child X 3). The maximum

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⁸¹ I.R.C. §§ 24(d)(2)(A)(ii), 1401 (2003). For purposes of Section 24(d), the term "social security taxes" also is defined to include one-half of the tax imposed on the income of each employee representative under Section 3211. I.R.C. § 24(d)(2)(A)(iii) (2003).
⁸² Section 32 provides that an individual with two or more qualifying children may claim an earned income credit of up to 40% of $8,890, or $3,556. I.R.C. § 32(a), (b)(1)(A), (b)(2)(A). The $8,890 amount (and therefore the $3,556 maximum amount of the earned income credit) is adjusted annually for inflation. I.R.C. § 32(j). For 2004, the maximum amount of the earned income credit that may be claimed for taxpayers with two or more qualifying children is $4,300. Rev. Proc. 2003–85 § 3.06(1), 2003–49 I.R.B. 1184. Under Section 32(b)(2), the otherwise allowable amount of the earned income credit is reduced by 21.06% of the adjusted gross income (or, if greater, earned income) exceeding $12,610 of married taxpayers filing a joint return who have two qualifying children. The $12,610 amount is adjusted annually for inflation. I.R.C. § 32(j). For 2004, the earned income credit is phased out for married taxpayers filing a joint return having two or more qualifying children and adjusted gross income (or, if greater, earned income) exceeding $15,040. Rev. Proc. 2003–85 § 3.06(1), 2003–49 I.R.B. 1184. Thus, in the example, the earned income credit for Angela and Bill is $781 for 2004 ($4,300 otherwise allowable earned income credit, reduced by $3,519 (21.06% of ($31,750 adjusted gross income - $15,040)).
³³ The employee’s share of the FICA tax is computed as 7.65% of an employee’s wages. I.R.C. § 3101(a), (b)(6) (2003). Thus, the couple’s FICA tax liability on the earned income of Angela and Bill is $2,429 (7.65% of $31,750).
allowable nonrefundable credit, however, is $655, based on the tax liability limitation (tax liability of $655).

The amount of the refundable credit is $2,100 (the lesser of: (1) $3,000 (the child tax credit allowed under Section 24(a), without regard to the tax liability limitation); or (2) (the greater of (a) $2,100 (10% of $21,000 (the amount by which $31,750 exceeds $10,750)) or (b) because the Jones have three qualifying children, $1,648 (the amount by which the Jones' $2,429 social security taxes exceed their $781 earned income credit)).

Under JGTRRA, some taxpayers were entitled to receive an advance payment of the increase in the child tax credit in 2003, using the taxpayer's 2002 tax return as the basis of information. To receive the advance payment, the taxpayer had to satisfy the following two prerequisites: (1) the taxpayer was allowed a child tax credit in 2002 and claimed the credit on the taxpayer's 2002 federal income tax return; and (2) the taxpayer had a qualifying child who was under the age of 17 as of December 31, 2003. The refundable child tax credit for families with three or more children was disregarded in determining the credit refund amount.

Taxpayers who were ineligible for the child tax credit in 2002 because they had too little or too much income to claim the credit were denied advance refunds of the credit in 2003. Indeed, it was determined that 6.5 million minimum wage families would not even receive, in an advanced payment or otherwise, the $400-per-child increase in the child tax credit under JGTRRA.

D. The Reduction in the Tax Rate on Adjusted Net Capital Gain and Certain Dividends

JGTRRA reduces the tax rate on adjusted net capital gain of an individual from 20% to 15% for sales of property and reduces the gain on installment payments received from May 6, 2003 through

88. See, e.g., Boom Times on the Poverty Rolls, N.Y. Times (Sept. 30, 2003), at A28. The Urban-Brookings Tax Policy Center, the Center on Budget and Policy Priorities, and Citizens for Tax Justice found that 6.5 million minimum-wage families, with nearly 12 million children, would not receive the $400-per-child increase in the child tax credit under JGTRRA. David Firestone, 2nd Study Finds Gaps in Tax Cuts, N.Y. Times (June 1, 2003), at A1.
December 31, 2008.\textsuperscript{89} Under JGTRRA, the maximum individual income tax rate on dividends from most U.S. and certain foreign corporations ("qualified dividend income") is reduced from 35\% to 15\% from January 1, 2003 through December 31, 2008.\textsuperscript{90} For taxpayers in the 15\% or 10\% income tax bracket, JGTRRA reduces the tax rate on adjusted net capital gain and dividends from 10\% to 5\% for qualified dividend income received and capital gains recognized between May 6, 2003, through December 31, 2007.\textsuperscript{91} Adjusted net capital gain recognized and dividends received by such taxpayers are not subject to tax in 2008.\textsuperscript{92} The reduced rates on adjusted net capital gain and qualified dividend income also apply for alternative minimum tax (AMT) purposes.\textsuperscript{93} After 2008, the maximum rate on adjusted net capital gain increases again to 20\% and the maximum rate on dividends increases to 35\%.\textsuperscript{94}

The capital gains rate reduction only affects adjusted net capital gain. The 28\% tax rate that applies to net capital gain on the sale or exchange of collectibles and Section 1202 gain,\textsuperscript{95} and the 25\% tax rate that applies to unrecaptured Section 1250 gain,\textsuperscript{96} remain the same. For this purpose, collectibles include any work of art, any rug or antique, any metal or gem, any stamp, certain coins other than bullion, and any alcoholic beverage.\textsuperscript{97} Section 1202 gain is the gain recognized on the sale or exchange of qualified small business stock in an amount equal to the amount of gain that is excluded from income under Section 1202.\textsuperscript{98} Unrecaptured Section 1250 gain generally is the portion of the gain recognized on the sale or exchange of depreciable real property held for more than one year to the extent that the gain is attributable to the amount of straight-line depreciation that reduced the adjusted basis in the property.\textsuperscript{99}

\begin{itemize}
\item \textsuperscript{92} \textit{Id.}
\item \textsuperscript{95} I.R.C. § 1(b)(4) (2003).
\item \textsuperscript{96} I.R.C. § 1(h)(6) (2003).
\item \textsuperscript{97} I.R.C. §§ 1(h)(5), 408(m) (2003).
\item \textsuperscript{98} I.R.C. § 1(h)(7) (2003).
\item \textsuperscript{99} I.R.C. § 1(h)(6) (2003).
\end{itemize}
Thus, in general, adjusted net capital gain is the gain recognized on the sale or exchange of a capital asset held for more than one year other than a collectible or qualified small business stock and other than the portion of the gain attributable to depreciation claimed with respect to real property.\(^\text{100}\) Adjusted net capital gain is the sum of the net capital gain (determined without regard to qualified dividend income), reduced (but not below zero) by the sum of: (a) unrecaptured Section 1250 gain, plus (b) 28% rate gain. I.R.C. § 1(h)(3)(A) (2003). To this amount, the taxpayer adds the taxpayer's qualified dividend income to determine the amount of the taxpayer's income that is subject to tax at a rate of 15% (or 5% (0% in 2008), in the case of a taxpayer whose highest income tax bracket is 10 or 15%). I.R.C.
capital gain includes, for example, gain on the sale or exchange of corporate stock or land held for investment\textsuperscript{101} and gain on the sale of real property held for the production of income or for use in a trade or business (to the extent that the gain is not attributable to prior depreciation deductions)\textsuperscript{102} if the taxpayer has held the property in question for more than one year.\textsuperscript{103}

JGTRRA reduces the individual income tax rate on qualified dividend income by treating such income as adjusted net capital gain included, for example, gain on the sale or exchange of corporate stock or land held for investment\textsuperscript{101} and gain on the sale of real property held for the production of income or for use in a trade or business (to the extent that the gain is not attributable to prior depreciation deductions)\textsuperscript{102} if the taxpayer has held the property in question for more than one year.\textsuperscript{103}

JGTRRA reduces the individual income tax rate on qualified dividend income by treating such income as adjusted net capital gain included, for example, gain on the sale or exchange of corporate stock or land held for investment\textsuperscript{101} and gain on the sale of real property held for the production of income or for use in a trade or business (to the extent that the gain is not attributable to prior depreciation deductions)\textsuperscript{102} if the taxpayer has held the property in question for more than one year.\textsuperscript{103}


\begin{footnotesize}
\begin{enumerate}
\item[101.] I.R.C. § 1221 (2003).
\item[102.] I.R.C. § 1231 (2003).
\item[103.] If real property is held for the production of income, it is a capital asset, and therefore, if such property is sold after it has been held for more than one year, the taxpayer will realize a long-term capital gain or loss. I.R.C. §§ 1221, 1222(3), (4) (2003). Real property used in a trade or business is not a capital asset. I.R.C. § 1221(a)(2) (2003). However, if real property used in a trade or business is held for more than one year and is not inventory or held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, such property is “property used in the trade or business” within the meaning of Section 1231(b)(1). In general, Section 1231 requires a taxpayer to net all of the taxpayer’s Section 1231 gains and losses for the year. Section 1231 gains or losses generally are gains and losses recognized on the sale or exchange of property used in the trade or business (i.e., personal property subject to an allowance for depreciation and real property used in a trade or business and held by the taxpayer for more than one year) and gains and losses recognized from the involuntary conversion (as a result of destruction in whole or in part, theft, seizure, or condemnation of property used in the trade or business or the involuntary conversion of any capital asset which is held for more than one year and held in connection with a trade or business or a transaction entered into for profit. I.R.C. § 1231(a)(3) (2003). Under Section 1231, the taxpayer first nets all of the taxpayer’s gains and losses from property involuntarily converted through fire, storm, shipwreck, or other casualty or theft. If the losses exceed the gains from such involuntary conversions for the year, such gains and losses are not taken into account in the Section 1231 netting process. I.R.C. § 1231(a)(4)(C) (2003). However, if the gains exceed the losses from such losses during the year, the gains and losses from involuntary conversions are taken into account in the netting process required by Section 1231. Where a taxpayer’s Section 1231 losses exceed the taxpayer’s Section 1231 gains for the year, all such gains and losses are treated as ordinary income and ordinary loss. I.R.C. § 1231(a)(2) (2003). In a case where a taxpayer’s Section 1231 gains exceed Section 1231 losses for the year, all of the taxpayer’s Section 1231 gains and losses are treated as long-term capital gains and losses. I.R.C. § 1231(a)(1) (2003). A recapture rule under Section 1231(c), however, requires a taxpayer to treat some or all of the taxpayer’s Section 1231 gains and losses for the year as ordinary income even if the gains exceed the losses in a year occurring within five years of the taxpayer’s recognizing a net Section 1231 loss that has not been treated as ordinary income under Section 1231(c) in an earlier year. I.R.C. § 1231(c) (2003). Thus, a taxpayer may recognize long-term capital gain on the sale of real property used in a trade or business and held for more than one year if the taxpayer’s Section 1231 gains exceed the taxpayer’s Section 1231 losses for the taxable year and no recapture of the gain as ordinary income is required under Section 1231(c).
\end{enumerate}
\end{footnotesize}
gain. Unlike the capital gain recognized on the sale or exchange of a capital asset, however, qualified dividend income is not reduced by capital losses.

For this purpose, the term "qualified dividend income" generally is defined as dividends received during the year from domestic and qualified foreign corporations. However, qualified dividend income does not include: (1) dividends from tax-exempt corporations, such as charities and farmers' cooperatives; (2) dividends that are deductible by mutual savings banks and other state- or federally-chartered savings institutions, and (3) dividends that are deductible by an employee stock ownership plan.

A foreign corporation is a qualified foreign corporation if the corporation is incorporated in a possession of the United States or if the corporation is eligible for benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines is satisfactory and which includes an exchange of information program. Dividends from stock in a foreign corporation also are eligible for the reduced rate of tax if the stock is readily tradable on an established securities market in the United States. However, a taxpayer must pay tax at the taxpayer’s marginal income tax rate (and not the reduced rate) on dividends from a foreign personal holding company (as defined in Section 552), a foreign investment company (as defined in Section 1246(b)), or a passive foreign investment company (as defined in Section 1297).

To enjoy the benefits of the reduced rate on qualified dividend income, a taxpayer must meet certain holding period requirements. Dividends from common stock will be eligible for the reduced rate under JGTRRA only if the taxpayer holds the stock for more than 60 days during the 120-day period that begins 60 days before the dividend is paid. In the case of preferred stock, the taxpayer must hold the stock for more than 90 days during the 180-day period beginning 90 days before the dividend is paid. Even if the holding period requirements are met, however, the taxpayer will not be eligible for the reduced rate of tax on dividends from the stock to the

extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.115

The reduction in the tax rate on dividends alleviates, to some extent, the double tax that applies to corporate income. The income of a C corporation sometimes is subject to a double tax because a C corporation pays tax on its income as it is earned,116 and the same income is subject to a second tax if and when it is distributed to shareholders as dividends.117 Presumably, Congress had the double tax in mind when it required shareholders to pay tax at ordinary income rates on dividends received from tax-exempt corporations such as charities and farmers' cooperatives and dividends that, when paid, are deductible by the distributing corporation. However, there does not seem to be a policy reason for allowing taxpayers to enjoy reduced rates of tax from foreign corporations. Foreign corporations generally are subject to U.S. federal income taxation only on income earned from sources within the United States.118 Where a foreign corporation has no U.S. source income, its income is not subject to U.S. tax. Dividends distributed by such a foreign corporation are subject only to a single U.S. income tax, paid by the distributee-shareholder. Thus, the corporate double tax should not have been a concern to Congress in reducing the individual income tax rate on dividends received from a foreign corporation.

The House Report indicates that, in reducing the tax rate on dividends, Congress intended to stimulate capital investment in corporations.119 That goal, if accomplished, could stimulate the U.S. economy if investments are made in domestic (U.S.) corporations. It is unclear why Congress would want to encourage taxpayers to invest in foreign corporations because such investments are unlikely to stimulate the U.S. economy.

Another reason for the reduction in the rate of tax on corporate dividends was to encourage corporations to seek equity contributions, rather than incurring debt, by equalizing the taxation of dividends and interest.120 While corporations are permitted to deduct interest payments on corporate debt,121 no deduction generally is allowed for dividends paid. If Congress really wanted to equal the tax burden on

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117. I.R.C. §§ 61(a)(7), 301(a) (2003). It has been estimated, however, that only one-fourth of corporate income is actually subject to a double tax. Burman, Gale & Orszag, supra note 5, at 1094 & n.7.
120. Id.
corporate debt and equity, however, it should have made dividends deductible by the corporation or else should have disallowed a deduction for corporate interest payments.

The reduction in the tax rate on dividends makes stock more attractive to shareholders than corporate bonds because interest income is still subject to ordinary income tax rates. However, the reduction in the tax rates does not eliminate the disparity between debt and equity financing. Corporate debt results in a single tax on corporate earnings because interest payments are deductible by a corporation\textsuperscript{122} and taxable to the bondholder,\textsuperscript{123} and principal payments on corporate debt are not deductible by the corporation and are not included in the income of the bondholder.\textsuperscript{124} In contrast, the reduction in the individual income tax rate on dividends does not eliminate the double tax on corporate earnings. Because a corporation may not deduct dividends, corporate income that is paid out as dividends still is subject to tax at the corporate level\textsuperscript{125} and is taxable again, albeit at a lower rate than the rate of tax that applies to ordinary income, when the corporate income is distributed to shareholders as a dividend.\textsuperscript{126}

The reduction in the tax rate on adjusted net capital gain and on qualified dividend income provides some planning opportunities to taxpayers. JGTRRA's rate reductions also may create headaches for taxpayers who engaged in certain transactions using planning based on the pre-JGTRRA rules and will cause some taxpayers to incur additional accounting fees for tax returns prepared for 2003. Some of the planning opportunities and problems created by the reduced rates on adjusted net capital gain under JGTRRA are discussed below.

1. \textit{Gifts to Children 14 Years and Older}

As a result of the reduction in the rate of tax on adjusted net capital gain under JGTRRA, a family may enjoy considerable tax reductions if capital assets are given to children who are 14 or older and in the 10\% or 15\% tax bracket. (The so-called "Kiddie Tax" requires most of the unearned income of a child under the age of 14 to be taxed at the parent's rate.)\textsuperscript{127} If stock is transferred to such a

\begin{itemize}
\item \textsuperscript{122} I.R.C. § 163(a) (2003).
\item \textsuperscript{123} I.R.C. § 61(a)(4) (2003).
\item \textsuperscript{124} The payment of principal amount of a debt is not income to the payee because it is a return of capital.
\item \textsuperscript{125} I.R.C. § 11 (2003).
\item \textsuperscript{126} I.R.C. §§ 1(h)(11), 61(a)(7), 301(a) (2003).
\item \textsuperscript{127} I.R.C. § 1(g) (2003). The child's "net unearned income" is the amount that is subject to the Kiddie Tax. For this purpose, the term "net unearned income" is
child, dividends will be taxable at a maximum rate of 5% (instead of 15%) from 2003–2007 and 0% in 2008. Where property is expected to be sold, transferring the property to a child who has attained the age of 14 and is in the 10- or 15% tax bracket may result in significant tax savings to the family. In such a case, the adjusted net capital gain will be taxed at 5% if the property is sold after May 5, 2003, and before December 31, 2007, and will be free from tax if the property is sold in 2008. If the property is to be held by the child after 2008, adjusted net capital gain may be subject to tax at a rate of 10% instead of 20%.

Taxpayers desiring to transfer property to a child in order to take advantage of the lower tax rate on the adjusted net capital gain on the sale of the property should take care to ensure that the income is treated as the income of the child, rather than the parent. For example, the title to the property should be passed to the child before negotiation for the sale of the property has begun. If the parent negotiates the sale before, and/or retains title to the property after, the property is transferred to the buyer, the gain may be taxed to the parent at the parent’s tax rate.

2. Section 83(b) Election With Respect to Restricted Stock

The reduction in the tax rates on adjusted net capital gain and dividends is likely to make a Section 83(b) election more attractive to an employee who receives restricted stock (e.g., stock that may be forfeited if the employee quits working for the company before a
certain number of years). Under Section 83(a), an employee who receives restricted stock generally does not include the value of the stock in income until the employee's ownership in the stock vests. 130 The delay in taxation can cause an employee who receives restricted stock to incur a large tax liability if the stock appreciates significantly in value during the vesting period.

Example #9: Assume that Joe, who works for XYZ, Inc., receives 300 shares of XYZ stock worth $30,000 on January 1, 2004. The stock certificates are stamped "non-transferrable until January 1, 2008," and the stock is subject to forfeiture by Joe if Joe ceases to work for XYZ any time before January 1, 2008. Under Section 83(a), Joe does not include the $30,000 value of the stock in income until the Joe's ownership rights in the stock vest. If the stock is worth $150,000 on January 1, 2008, when Joe's rights in the stock vest, Joe must pay tax, at ordinary income rates, on $150,000.

Because stock received in exchange for services is treated as compensation for the employee's services, 131 the value of the stock is taxed at ordinary income rates 132 and may be subject to social security taxes 133 whenever the employee includes it in income. 134 Section 83(b) may help an employee avoid the potential of an increased tax liability under Section 83(a). Under Section 83(b), an employee may elect to include in income the value of the restricted stock when the stock is received.

For example, if Joe had made a Section 83(b) election when he received the restricted stock, Joe would have included the $30,000 fair market value of the stock in ordinary income and would have been liable for social security tax on $30,000 in 2004. Upon making the Section 83(b) election, Joe would have a $30,000 basis in the stock. 135 Later, when the stock appreciates in value to $150,000, Joe will not be liable for any further tax on the stock. Joe then could sell the stock for $150,000 and pay tax at capital gains rates on the $120,000 gain. A Section 83(b) election may be useful if the employee plans to continue to work for the company until ownership in the stock vests and expects the value of the stock to increase.

133. I.R.C. §§ 3401(a), 3402(a) (2003).
134. The discussion in the text is overly simplified. The value of the stock, reduced by the amount, if any, that the employee pays for the stock is treated as compensation for the employee's services under Section 83(a). I.R.C. § 83(a) (2003).
The reduction in the capital gains rate and the tax on dividends makes the Section 83(b) election more attractive. If a Section 83(b) election is made, the employee can sell the stock at capital gains rates if the employee holds the stock for more than one year after the date of the election.136 The maximum tax rate that will apply to dividends from the stock during the period from 2003 through 2008 is 15% if the employee makes the election.137 If no Section 83(b) election is made, all dividends are treated as salary to the employee because the employee is not considered to own the stock.138 Thus, without a Section 83(b) election, dividends from restricted stock are taxed at a maximum rate of 35% and are subject to social security taxes.

An employee who receives restricted stock, however, should make a Section 83(b) election only after careful deliberation.139 A Section 83(b) election may result in adverse tax results. If an employee makes a Section 83(b) election and later forfeits the stock for failure to meet the vesting requirements, the employee will not be permitted to claim a deduction for the amount that previously was included in income.140 Thus, Section 83(b) offers an employee a "gambler's choice."141 Where an employee expects to remain employed by the corporation until the employee's interest in the stock vests and expects the value of restricted stock to increase, a Section 83(b) election may provide significant benefits. However, if there is uncertainty as to whether the employee will continue to be employed until vesting or if there is a significant chance that the stock will

136. See Treas. Reg. § 1.83–4(a) (2003) (holding period in property received in exchange for personal services begins just after the property is substantially vested; but if the service provider makes a Section 83(b) election, the holding period begins just after the date that the property is transferred); see also Treas. Reg. § 1.83–2(a) (2003) (a service provider that makes a Section 83(b) election is not treated as receiving compensation for any appreciation in the property after the property is transferred to the service provider in exchange for services).

137. Treasury Regulation § 1.83–2(a) provides that if a service provider makes a Section 83(b) election with respect to substantially nonvested property received in exchange for services, the substantial vesting rules of Section 83(a) and the regulations thereunder do not apply. Thus the rule of Treasury Regulation § 1.83–1(a) (treating the transferor, rather than the service provider, as owning the transferred property where the property is substantially nonvested) does not apply in a case where the service provider has made a Section 83(b) election.


139. However, an employee may not wait too long to make a Section 83(b) election. The election must be made no later than 30 days after the employee receives the restricted stock. Treas. Reg. § 1.83–2(b) (2003).

140. I.R.C. § 83(b) (2003).

decline in value during the pre-vesting period, a Section 83(b) election may be detrimental, especially if the stock is not likely to pay large amounts of dividends.

3. Charitable Giving

The reduction in the rates on capital gains is likely to discourage taxpayers from donating property to charities. A taxpayer may claim a charitable deduction for the fair market value of capital assets held for more than one year ("capital gain property") given to a charity without recognizing gain. Because adjusted net capital gain is subject to a maximum tax rate of 15% (or 5% (0% in 2008) if a taxpayer is in the 10% or 15% tax bracket), taxpayers are more likely to sell or give capital assets such as corporate stock or land held for investment to family members in low tax brackets than to give such assets to charities.

Example #10: Frances, who is in the 35% tax bracket, owns stock worth $50,000, with a $20,000 basis. Assuming that Frances is allowed to claim a charitable deduction in an amount equal to the fair market value of the stock if she donates it to charity, the donation of the stock will result in a tax savings of $17,5000 (35% X $50,000), which is less than Frances's $20,000 investment in the stock. If Frances sells the stock, Frances will pay $4,500 tax (15% X $30,000 gain) and have cash of $50,000. The sale of the stock would result in a $25,500 after-tax return on Frances's investment ($50,000 cash received - $4,500 tax liability - $20,000 investment in the stock).

142. I.R.C. § 170(a)(1), (c) (2003). Under Section 170(e)(1)(A), the amount of a charitable contribution (i.e., the fair market value of property, in the case of a contribution of property other than cash) is reduced by the amount of gain that would not be long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of the contribution). By negative implication, a taxpayer may deduct the fair market value of capital gain property contributed to a charity. However, if a taxpayer contributes tangible personal property to a charity that the charity will not use for the purpose or function constituting the basis for the charity's exemption from tax under Section 501 or if the taxpayer contributes property other than qualified appreciated stock (generally publicly traded stock) to or for the use of a nonoperating private foundation, the amount of the taxpayer's deduction is limited to the taxpayer's adjusted basis in such capital gain property. I.R.C. § 170(e)(1)(B), (5) (2003). For purposes of Section 170, property used in a trade or business (as defined in Section 1231(b)) is treated as a capital asset (except to the extent that the taxpayer would recognize ordinary income on a sale or exchange of the property under Sections 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a)). I.R.C. § 170(e)(1) (2003), flush language.
The reduction in the tax rates on ordinary income under JGTRRA also may make charitable contributions of other types of capital assets, such as art collections and other collectibles, less attractive to taxpayers. Under Section 1(h), gain on the sale or exchange of a collectible by an individual is subject to a maximum tax rate of 28%\textsuperscript{143} The 7% differential between the 28% maximum rate of tax that applies to gain on the sale of a collectible and the 35% maximum rate of tax that applies to ordinary income may discourage wealthy taxpayers from contributing collectibles to charities.

Example #11: Assume the same facts as in Example #10, except that Frances owns a painting worth $100,000 that Frances purchased several years ago for $40,000. If Frances donates the painting to an art museum, Frances may claim a charitable deduction of $100,000, resulting in a tax savings of $35,000, which is less than Frances’s investment in the painting. If Frances sells the painting for $100,000, Frances will recognize a gain of $60,000 ($100,000 amount realized - $40,000 basis in the painting). Frances will pay $16,800 of tax (28% of $60,000) on the $60,000 gain. Thus, the sale of the painting results in an after-tax profit of $43,200 ($100,000 cash received - $16,800 tax liability - $40,000 investment), and Frances will have $100,000 of cash to spend or save at Frances’s convenience.

4. Section 1202 Stock

Section 1202 generally permits taxpayers who purchase stock in certain small business corporations ("Section 1202 stock") to exclude half of up to $10 million the gain recognized on the sale of the stock if they hold the stock for more than 5 years. The type of corporation whose stock qualifies as Section 1202 stock generally is a C corporation that engages in a high-tech business or a specialized small business investment company.\textsuperscript{144}

\textsuperscript{143} I.R.C. §§ 1(h)(4)(A)(i), (5)(A), 408(m) (2003).
\textsuperscript{144} Section 1202 permits a taxpayer other than a corporation to exclude 50% of the greater of $10 million ($5 million, in the case of a married taxpayer filing a separate income tax return) per corporation of the gain recognized on the sale or exchange of qualified small business stock held for more than five years (referred to in the text as "Section 1202 stock") or ten times the aggregate adjusted bases of qualified small business stock issued by that corporation and disposed of by the taxpayer in the taxable year. I.R.C. § 1202(a)(1), (b) (2003). For this purpose, "qualified small business stock" generally is defined as stock issued by a C corporation after August 10, 1993 if: (1) as of the date the stock is issued, the corporation is a qualified small business; and (2) the stock was acquired by the taxpayer at its original issue (either directly or through an underwriter) in exchange
The half of the gain on the sale or exchange of Section 1202 stock that is recognized is subject to a maximum tax rate of 28%.145 Thus, the effective maximum tax rate on up to $10,000 of gain recognized on the sale or exchange of Section 1202 stock is 14%. JGTRRA does not change this result, but reduces the amount of the excluded portion of the gain on Section 1202 stock subject to the alternative minimum tax ("AMT") from 42% to 7%.146

The 15% rate that applies to adjusted net capital gain under the JGTRRA may make it attractive to sell Section 1202 stock before the 5-year holding period has expired. In that case, the gain realized will be subject to a 15% rate for both regular tax and alternative minimum tax ("AMT") purposes.147 In contrast, the gain realized on a sale after the 5-year holding period will be subject to an effective regular tax rate of 14% and an AMT rate of 13.91% or 14.98%, depending on the

for money or other property (not including stock) or as compensation for services provided to the corporation (other than services as an underwriter). I.R.C. § 1202(c)(1) (2003). A corporation is a qualified small business if: (1) the aggregate gross assets of the corporation (or any predecessor thereof) at all times on or after the August 10, 1993, effective date of the Revenue Reconciliation Act of 1993 and before the stock is issued, did not exceed $50 million; (2) the aggregate gross assets (i.e., the amount of money and the aggregate adjusted bases of other property held by the corporation) of the corporation immediately after the issuance of the stock (determined by taking into account amounts received in the issuance) do not exceed $50 million; and (3) the corporation agrees to submit to the Internal Revenue Service (the "Service") and to shareholders any reports required by the Service to carry out the purposes of Section 1202. I.R.C. § 1202(d)(1), (2) (2003). Stock other than stock in a specialized small business investment company is not treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for the stock, the corporation meets the active business requirement. I.R.C. § 1202(c)(2) (2003). For a corporation to meet the active business requirement, at least 80% (by value) of the corporation's assets must be used by the corporation in the active conduct of one or more qualified trades or businesses and the corporation must be an eligible corporation. I.R.C. § 1202(e)(1) (2003). In general, a qualified trade or business is any trade or business other than: (1) a professional services business; (2) a banking, insurance, financing, leasing, investing, or similar business; (3) a farming business; (3) a business involving the production or extraction of minerals; (4) a business of operating a hotel, motel, restaurant, or similar business. I.R.C. § 1202(e)(3) (2003). An eligible corporation generally is any domestic corporation except: (1) a DISC or a former DISC; (2) a corporation with respect to which an election under Section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect; (3) a regulated investment company, real estate investment trust, REMIC, or FASIT; and (4) a cooperative. I.R.C. § 1202(c)(4) (2003).

taxpayer's AMT bracket (26% or 28%). The small tax savings may not be worth the risk that the stock will decline in value during the 5-year holding period. Section 1202 was enacted in 1993, when the maximum tax rate for all net capital gain, including adjusted net capital gain, was 28%. By allowing a taxpayer to exclude up to one-half of the gain on the sale or exchange of qualified small business stock, Congress reduced the maximum tax rate on such gain to 14%. At the time, Section 1202 offered an incentive to invest in high-tech, start-up companies and in corporations that invested in such companies. JGTRRA has reduced practically all of the advantages of investing in Section 1202 stock. While a taxpayer must hold Section 1202 stock for more than five years to take advantage of the 14% tax rate that applies to up to $10 million of the gain on the sale or exchange of such stock, JGTRRA allows a taxpayer to invest in any corporation, hold the stock for 366 days, and sell the stock, recognizing all of the gain at a maximum rate of 15%. Not only does an investor avoid the risk of Section 1202 stock declining in value during the five-year period, but the time value of money makes the cash received on a sale of the stock in an earlier year worth more than the same amount of cash that might be received on the sale of the stock in a later year.

5. The 2001 Deemed Sale Election

In 1997, when Congress reduced the rates that apply to net capital gain, it included an 18% rate that applied to adjusted net capital gain...
on the sale of an asset purchased after December 31, 2000, and held for more than 5 years, if the gain otherwise would be subject to a rate of 20% ("qualified five-year gain"). Thus, for example, a taxpayer who purchased stock for investment on January 1, 2001, had to wait until January 1, 2006, before selling the stock to enjoy the benefit of the maximum 18% rate that would apply to the qualified five-year gain. A taxpayer holding a capital asset before January 1, 2001, was permitted to make an election on January 1, 2001, to treat the asset as if the taxpayer had sold the asset on that date. The election triggered recognition of gain (but not loss) on the deemed sale in 2001, and increased the taxpayer's basis in the property. The election, once made, was irrevocable.

JGTRRA repeals the 18% tax rate on such qualified 5-year gain. All adjusted net capital gain is taxed at a maximum rate of 15% during the period from May 6, 2003 through December 31, 2008. JGTRRA is silent with respect to taxpayers who made the deemed sale election in 2001. Such taxpayers, however, may want to file amended returns for 2001 revoking the election, in the hope that Congress will enact legislation allowing revocation.

6. Choosing Investments

As explained earlier, the reduced rates on dividends under JGTRRA may make investing in stock more attractive than purchasing bonds or investing in savings accounts. While qualified dividends are taxed at a maximum rate of 15% from 2003 through 2008, interest is subject to a maximum tax rate of 35%.

Many taxpayers, however, will not be entitled to take advantage of the reduced rates on adjusted net capital gain because they have purchased stock through qualified retirement accounts and individual retirement accounts ("IRAs"). The capital gains and dividends received by such accounts are tax-deferred, but when distributed

are subject to tax at ordinary income tax rates.\textsuperscript{159} The reduction in the tax rates on adjusted net capital gain and dividends may encourage some taxpayers to invest more in stock that is held outside of tax deferred accounts.

The reduced rates for dividends also may encourage taxpayers to purchase dividend-paying stock, rather than stock to be held for future capital gains. It is likely that the reduced rates will distort corporate decisions because shareholders will pressure corporate officers to declare dividends rather than investing profits in the company. Shareholder pressure may result in reduced purchases by corporations of new business equipment and reduced corporate investment in research and development activities.

7. Installment Sales

The rate reductions on adjusted net capital gain may tempt some taxpayers to elect out of installment sale reporting. Under the installment method, a taxpayer defers gain, reporting only a portion of the gain realized on a sale of property as each installment payment is received.\textsuperscript{160} If a taxpayer elects out of installment sale reporting, all gain generally is recognized in the year of the sale.\textsuperscript{161} Because the

\textsuperscript{159} I.R.C. §§ 72, 402(a), 403(a), 406(a), 408(d)(1) (2003). \textit{But see} I.R.C. § 402A(d) (2003) (distributions from a Roth IRA exempt from tax).

\textsuperscript{160} I.R.C. § 453(c) (2003).

\textsuperscript{161} Section 453(d) allows a taxpayer to elect not to use the installment method of reporting the taxpayer's gain from an installment sale. In most cases, an election out of the installment method will result in the recognition of all of the gain realized in the year of the sale. Temp. Treas. Reg. § 15a.453–1(d)(2) (2003). In rare cases where it is impossible to determine the amount of gain that the taxpayer will realize over the life of the installment sale contract, the courts have allowed taxpayers who elect out of the installment method to report gain to use the open method of reporting gain. \textit{See}, \textit{e.g.}, Burnet v. Logan, 283 U.S. 404, 51 S. Ct. 550 (1931). Under the open method of reporting gain, an installment seller will first apply all payments against the taxpayer's basis in the property, recognizing gain only after the taxpayer's adjusted basis in the property has been recovered. Open reporting of gain, however, generally is allowed only when it is impossible to determine the fair market value of the amount to be realized on the sale or the fair market value of the property that has been transferred in the sale. Generally, when a sale occurs as a result of an arms'-length bargain, the fair market value of the property received (i.e., the installment obligation in this context) is presumed to be equal to the fair market value of the property transferred in the sale. Temp. Treas. Reg. § 15a.453–1(d)(2)(iii) (2003). \textit{See also} Philadelphia Amusement Park Co. v. United States, 126 F. Supp. 184 (Ct.Cl. 1954). The regulations provide detailed rules for reporting gain on the installment method when the amount to be received under an installment contract is contingent, for example on profits to be derived from the property transferred in the sale. Temp. Treas. Reg. § 15a.453–1(c) (2003). The regulations provide that only in rare and extraordinary cases involving sales for a contingent payment in which the fair market value of the installment obligation
reduced capital gain rates apply only on installment payments received from 2003 until 2008, some taxpayers may desire to pay tax on all of the gain in the year of the sale at 15% rather than paying a 20% tax on payments received after 2008. Electing out of installment sale reporting will be particularly valuable to taxpayers in the 15% or 10% tax bracket who sell property in 2008 when their adjusted net capital gain will be taxed at 0%.

In many cases, however, a taxpayer should weigh the benefits of paying 15% tax on accelerated installment sale gain in the year of the sale against the benefit of using the installment method and deferring the gain, even though a portion of the gain will be taxed at 20% with respect to payments made after 2008. Especially because the rate differential is only 5%, the time value of money may make deferral more valuable than acceleration of gain.  

8. Tax Returns

The reduced rates on adjusted net capital gain will add complications for the 2003 filing season. The reduced rates on gain on the sale of capital assets and receipt of installment payments in 2003 only applies to sales occurring or the receipt of an installment payment on or after May 6, 2003. A complicated transitional rule applies in calculating the tax on an individual’s adjusted net capital gain for 2003. In this respect, JGTRRA adds tremendous complexity and is likely to increase taxpayers’ compliance costs during the 2003 tax return filing season.

E. First-Year Bonus Depreciation

JGTRRA increases the amount of additional first-year depreciation ("bonus depreciation") that a taxpayer may deduct with respect to certain property placed in service after May 5, 2003. The Job Creation and Worker Assistance Act of 2002 (JCWAA) added Section 168(k) which allows a taxpayer to deduct 30% of the cost of certain depreciable property ("qualified property") acquired after September 10, 2001, and placed in service before January 1, 2005 (January 1, 2006, in the case of property that is: (1) produced by the taxpayer and cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is “open.” Temp. Treas. Reg. § 15a.453–1(d)(2)(iii) (2003).

162. For a definition of the term, “the time value of money,” see supra note 20.
164. Id.
165. A brief glance at the 2003 Schedule D for Form 1040 illustrates the headaches that many taxpayers will face in filing 2003 federal income tax returns.
subject to the uniform capitalization rules under Section 263A; (2) has a production period greater than two years, or greater than one year and a cost of more than $1 million; and (3) has a recovery period of at least ten years and is used in the trade or business of transporting persons for hire). The bonus depreciation allowed under Section 168(k) applies, both for regular income tax purposes and for purposes of the alternative minimum tax. JGTRRA increases the allowable depreciation under Section 168(k) to 50% of the cost of such property if: (1) the original use of the property commences with the taxpayer after May 5, 2003; (2) the property is acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before May 6, 2003; and (3) the property is placed in service before January 1, 2005, or before January 1, 2006, in the case of property described in the preceding parenthetical.

For purposes of Section 168(k), the term “qualified property” is defined to include: (1) tangible property eligible for the modified accelerated cost recovery system (“MACRS”) under Section 168 that has a recovery period of 20 years or less; (2) MACRS water utility property; (3) computer software depreciable over three years under Section 167; and (4) qualified leasehold improvement property. An improvement to the interior portion of a building that is nonresidential real property may be treated as qualified leasehold improvement property if the improvement is made pursuant to a lease by the lessee, sublessee, or lessor, the property is occupied exclusively by the lessee (or a sublessee), and the improvement is placed in service more than three years after the date the building was first placed in service. However, qualified leasehold improvement property does not include any expenditures for: (1) the enlargement of the building; (2) an elevator or escalator; (3) a structural component benefitting a common area; or (4) the internal structural framework of the building. Expenditures for an improvement will not qualify if the lessor and the lessee are related persons.

172. I.R.C. § 168(k)(3)(C)(ii) (2003). For this purpose, persons are treated as related persons if they are members of an affiliated group of corporations within the meaning of Section 1504 or if they are related within the meaning of Section 267(b), except that, for purposes of Section 168(k)(3) the phrase “80 percent or
The accelerated depreciation under Section 168(k) is allowed in addition to the depreciation deduction that otherwise is allowable under Section 168. In computing a taxpayer's first-year depreciation deduction for qualified property, the taxpayer first reduces the adjusted basis of the property by the amount of depreciation allowed under Section 168(k) and then determines the otherwise allowable depreciation deduction by reference to the reduced basis.

A taxpayer may elect out of the 50% bonus depreciation allowed under Section 168(k). A taxpayer that does not want to use the 50% bonus depreciation will use the 30% bonus depreciation allowed under JCWAA unless the taxpayer elects out of the 30% bonus depreciation. Thus, a taxpayer may choose to claim 50% bonus depreciation, 30% bonus depreciation, or no bonus depreciation with respect to qualified property placed in service in 2004. If the taxpayer elects not to claim 50% bonus depreciation and/or 30% bonus depreciation with respect to any class of property for the taxable year, the election applies to all property of the same class placed in service during the taxable year.

A special rule under Section 168(k) applies for depreciation claimed for passenger automobiles. Section 280F limits the amount of annual depreciation deductions a taxpayer may claim with respect to certain so-called "luxury" automobiles. A taxpayer that placed such a passenger automobile in service and used the automobile exclusively in connection with a trade or business in 2003 generally is permitted to claim the following maximum amount depreciation deductions per year under Section 280F:

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Tax Year</td>
<td>$3,060</td>
</tr>
<tr>
<td>2nd Tax Year</td>
<td>$4,900</td>
</tr>
<tr>
<td>3rd Tax Year</td>
<td>$2,950</td>
</tr>
<tr>
<td>Each Succeeding Tax Year</td>
<td>$1,775</td>
</tr>
</tbody>
</table>

more" is substituted for the phrase "more than 50 percent" each place it appears in Section 267(b). ld.

174. Id.
178. Section 280F(a)(1)(A) provides that the maximum amount of depreciation that a taxpayer may claim with respect to a passenger automobile may not exceed: (i) $2,560 for the first taxable year in the recovery period; (ii) $4,100 for the second
For purposes of Section 280F, the term "passenger automobile" generally is defined as any four-wheel vehicle that is manufactured primarily for use on public streets, roads, and highways, and which is rated at 6,000 pounds unloaded gross vehicle weight or less.\textsuperscript{179} In the case of a truck or a van, the foregoing definition is applied by substituting the term "gross vehicle weight" for "unloaded gross vehicle weight."\textsuperscript{180} This definition excludes certain trucks and sports utility vehicles ("SUVs") that weigh more than 6,000 pounds. The depreciation schedule with respect to such trucks and SUVs weighing over 6,000 pounds that are used predominantly in a taxpayer's trade or business (\textit{i.e.}, more than 50\% of use of the vehicle during the taxable year is attributable to use in a trade or business) is not subject to the limitations of Section 280F.\textsuperscript{181}

JCWAA and JGTRRA increased the annual depreciation allowances with respect to passenger automobiles. Under JCWAA, the maximum first-year depreciation deduction a passenger

\begin{itemize}
  \item year in the recovery period; (iii) $2,450 for the third taxable year in the recovery period; and (iv) $1,475 for each succeeding taxable year. I.R.C. § 280 F(a)(1)(a) (2003). These amounts are adjusted annually for inflation. I.R.C. § 280F(d)(7) (2003). The table in the text reflects the inflation adjustments for 2003. Rev. Proc. 2003–75 § 4.02(2) Table 1, 2003–45 I.R.B. 1018. As of this writing, the Internal Revenue Service has not yet released the inflation adjustments for depreciation on passenger automobiles for 2004.
  \item I.R.C. § 280F(d)(5)(A) (2003). The term "passenger automobile," however, does not include: (1) any ambulance, hearse, or combination of ambulance-hearse used by the taxpayer directly in a trade or business; (2) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire; and (3) any truck or van which, by reason of its design, is not likely to be used more than a de minimis amount for personal purposes. I.R.C. § 280F(d)(5)(B) (2003); Treas. Reg. §§ 1.274–5T(k)(2), 1.280F–5T(c)(3)(iii) (2003).
  \item Under Section 280F, any property used as a means of transportation, including a passenger automobile, truck, or SUV, is listed property. I.R.C. § 280F(d)(4)(ii) (2003). To be eligible for the accelerated MACRS depreciation under Section 168(b), listed property must be used predominantly in a qualified business use. I.R.C. § 280F(b)(1) (2003). For this purpose, property is used predominantly in a qualified business use if the business use percentage for the taxable year exceeds 50\%. I.R.C. § 280F(b)(3) (2003). In general, business use percentage means the percentage use of any listed property during the taxable year which is any use in a trade or business. I.R.C. § 280F(d)(6) (2003). If listed property is not used predominantly in a qualified business use for the taxable year, the annual depreciation allowed is subject to the alternative depreciation system of Section 168(g), which generally allows the taxpayer to claim straight line depreciation deductions, rather than using the 200\% or 150\% declining balance method allowed under the MACRS provisions of Section 168(b)(1), (2). I.R.C. § 280F(b)(1) (2003). Greater amounts of annual depreciation also are allowed for so-called "clean-fuel" passenger automobiles (\textit{i.e.}, electric automobiles) placed in service after August 5 and before January 1, 2007. I.R.C. § 280F(a)(1)(c) (2003).
automobile placed in service for 2003 (where the taxpayer elects to use the 30% bonus depreciation allowance) is increased to $7,660.\textsuperscript{182} JGTRRA increases the maximum first-year depreciation deduction for such a passenger automobile to $10,710 in a case where the taxpayer does not elect out of the 50% bonus depreciation allowance under Section 168(k).\textsuperscript{183}

The increased first-year depreciation allowance under Section 168(k) was intended to accelerate purchases of equipment, to promote capital investment, modernization, and growth, and to help spur an economic recovery.\textsuperscript{184} Congress believed that the acceleration of purchases of business equipment would increase employment as manufacturers hire more workers to produce that equipment and would increase employment opportunities in the years ahead.\textsuperscript{185}

Some taxpayers, however, may not desire to claim first-year bonus depreciation. As explained earlier, JGTRRA reduced the individual income tax rates and eliminated the marriage penalty with respect to the 15% tax bracket and the standard deduction for 2003 and 2004. If a taxpayer expects to be in a higher tax bracket in 2005 than in 2003 or 2004, it might be more advantageous to forego claiming large first-year bonus depreciation deductions in 2003 or 2004 so that depreciation deductions in 2005 will be larger. Even though Congress did not change the corporate income tax rates, a corporation that expects to be in a higher tax bracket in a later year also may prefer to elect out of claiming first-year bonus depreciation.

The reduced tax rates for individuals provide less incentive for small businesses that operate through pass-through entities, such as S corporations and LLCs, to invest in new equipment.\textsuperscript{186} In this respect, JGTRRA may undermine some of its own objectives.


\textsuperscript{185} Id.

\textsuperscript{186} Partnerships, LLCs that are classified as partnerships, and S corporations generally do not pay tax on the income they earn. I.R.C. §§ 701, 1363(a) (2003). Instead, the owners of the interests in such entities pay tax on their shares of the entity’s income as it is earned. I.R.C. § 702(a), 1366(a) (2003). Thus, an individual that owns an interest in a partnership, LLC classified as a partnership, or an S corporation pays tax on the individual’s share of the entity’s income at the individual’s marginal income tax rate.
F. Section 179 Expensing Limitations

JGTRRA increases the amount of Section 179 “expensing” that a taxpayer may claim with respect to property placed in service in taxable years beginning after 2002 and before 2006.\(^{187}\) Section 179 allows a taxpayer to elect to deduct (“expense,” rather than capitalize) part or all of the cost of Section 179 property. For this purpose, the term “Section 179 property” generally is defined to include tangible personal property purchased for use in a trade or business and used predominantly in a trade or business (i.e., more than 50% of the use of the property must be in connection with a trade or business).\(^{188}\)

Before it was amended in 2003, Section 179 allowed a taxpayer to expense up to $25,000 of the cost of Section 179 property placed in service during the taxable year.\(^{189}\) The $25,000 maximum expensing allowance was reduced, dollar-for-dollar by the amount by which the cost of Section 179 property placed in service during the taxable year exceeded $200,000.\(^{190}\) JGTRRA increases the $25,000 Section 179 allowance to $100,000 and the $200,000 limitation to $400,000 for Section 179 property placed in service in a taxable year beginning in 2003, 2004, or 2005.\(^{191}\) The $100,000 and $400,000 amounts are increased annually for inflation.\(^{192}\) Once a taxpayer elects to claim Section 179 expensing for taxable years beginning in 2003, 2004, and 2005, the taxpayer may revoke the election before 2006, but once a taxpayer has revoked a Section 179 election, the taxpayer may not reinstate the election.\(^{193}\)

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\(^{190}\) I.R.C. § 179(b)(2) (2003), amended by Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 202(b), 117 Stat. 752 (2003). The maximum amount of Section 179 expensing that a taxpayer may claim for a taxable year also is limited to the aggregate amount of the taxpayer’s taxable income for the year which is derived from the active conduct of a trade or business by the taxpayer during the taxable year. I.R.C. § 179(b)(3)(A) (2003). Any amount disallowed because of the gross income limitation is carried forward and may be claimed as a deduction in a year in which all of the requirements of Section 179 are met but the taxpayer has not placed in service Section 179 property up the maximum amount allowed for that year. I.R.C. § 179(b)(3)(B) (2003).


The amount of Section 179 expensing that a taxpayer claims with respect to an item of property reduces the adjusted basis of the property. A taxpayer computes the annual depreciation deductions with respect to property for which a Section 179 election has been claimed after taking into account the reduction in basis under Section 179. Thus, reduction in basis under Section 179 reduces the amount of depreciation that will be allowable for Section 179 property in future years. A taxpayer that expects to be in a higher income tax bracket in a later year may prefer to forego the Section 179 election in order to use larger depreciation deductions to offset income earned in later years.

The increased first-year depreciation allowance under Section 168 and the increased Section 179 expensing allowance under JGTRRA may have the unintended effect of encouraging taxpayers who otherwise would purchase passenger automobiles for use in a business to purchase less fuel-efficient vehicles such as SUVs and trucks weighing over 6,000 pounds. As explained earlier, SUVs and trucks weighing over 6,000 pounds are not subject to the Section 280F limitations on depreciation of passenger vehicles. While JGTRRA increases the amount of first-year depreciation allowed for passenger vehicles, the maximum amount of both Section 168 deductions and Section 179 expensing that a taxpayer may claim with respect to a passenger automobile placed in service in 2003 is $10,710. In contrast, Section 179 allows a taxpayer to deduct the entire $35,000 to $78,000 cost of an SUV weighing over 6,000 pounds and placed in service any taxable year beginning after 2002 and before 2006.

G. Alternative Minimum Tax Relief

JGTRRA increases the exemption amount for purposes of determining an individual’s alternative minimum tax (“AMT”) liability

195. Section 179(a) treats the amount of Section 179 expensing claimed as an "expense," thus allowing a current deduction rather than treating the portion of the cost of the property for which Section 179 expensing is claimed as a capital expenditure. Thus, if a taxpayer makes a Section 179 election with respect to property, the amount deducted in the year in which the property is placed in service is not included in the adjusted basis of the property for purposes of determining the annual depreciation deductions for the property. I.R.C. § 179(a) (2003).
196. See Temp. Treas. Reg. § 1.280F–2T(b)(4) (2003) (the amount of Section 179 deductions is subject to the limitations of I.R.C. § 280F(a)); see also Rev. Proc. 2003–75 § 4.02(2) Table 3, 2003–45 I.R.B. 1018 (maximum first-year depreciation allowed with respect to passenger automobiles placed in service in 2003 is $10,710.)
197. The range of costs to purchase such SUVs provided in the text is approximate. For the actual cost of an SUV, an individual should check a local dealership.
for 2003 and 2004.\textsuperscript{198} A taxpayer must pay the AMT if and to the extent that the taxpayer's tentative minimum tax exceeds the regular tax.\textsuperscript{199} The tentative minimum tax for a taxpayer other than a corporation is the sum of: (1) 26\% of the first $175,000 ($87,500 for married taxpayers filing separately) of a taxpayer's alternative minimum taxable income ("AMTI") in excess of the exemption amount; and (2) 28\% of the remaining AMTI.\textsuperscript{200}

Before 2003, the AMT exemption amount was $45,000 for married taxpayers filing joint returns and surviving spouses, $33,750 for unmarried taxpayers, and $27,500 for married taxpayers filing separate returns.\textsuperscript{201} JGTRRA increases the exemption amount for 2003 and 2004 to $58,000 for married taxpayers filing joint returns and surviving spouses, $40,250 for unmarried taxpayers, and $29,000 for married taxpayers filing separate returns.\textsuperscript{202} In 2005, the exemption amounts for such filers return to their pre-2003 levels.\textsuperscript{203}

The AMT exemption amounts are phased out for taxpayers with high AMTI. The exemption amount of any taxpayer is reduced by an amount equal to 25\% of the amount by which the AMTI exceeds: (1) $150,000 for married taxpayers filing joint returns; (2) $112,500 for unmarried taxpayers; and (3) $75,000 for married taxpayers filing separate returns.\textsuperscript{204} Under this formula, the 2003-2004 AMTI exemption amount is completely phased out for: (1) married taxpayers filing joint returns and surviving spouses who have AMTI of $382,000 or more; (2) unmarried taxpayers who have AMTI of $273,500 or more; and (3) married taxpayers filing separate returns who have AMTI of $191,000 or more. The exemption amounts and the phase-out amounts are not adjusted for inflation.

Married taxpayers filing separate returns can be subject to an additional AMT liability. A separate filer whose AMTI exceeds the $173,000 phase-out ceiling in 2004 must add back to his or her AMTI the lesser of: (1) 25\% of the amount by which AMTI (determined without regard to the add-back amount) exceeds the $191,000 phase-out ceiling; or (2) an amount equal to the $29,000 exemption amount for married taxpayers filing separate returns.\textsuperscript{205}

\begin{itemize}
\item \textsuperscript{199} I.R.C. § 55(a) (2003).
\item \textsuperscript{200} I.R.C. § 55(b) (2003).
\item \textsuperscript{202} Id.
\item \textsuperscript{203} Id.
\item \textsuperscript{204} I.R.C. § 55(d)(3) (2003).
\item \textsuperscript{205} I.R.C. § 55(d)(3) (2003), flush language.
\end{itemize}
Under this formula, a married taxpayer filing a separate return who has AMTI in excess of $307,000 will be required to add back $29,000 to AMTI.

To compute an individual taxpayer's AMTI, the taxpayer begins with taxable income, makes certain adjustments to taxable income, and adds back so-called "tax-preference" items. The adjustments and add-back items create a broader base of income for the AMT than is used in computing a taxpayer's regular income tax liability. For example, in computing AMTI a taxpayer generally must use slower depreciation schedules than otherwise are allowed under MACRS and may claim a deduction for medical expenses only to the extent that the taxpayer's unreimbursed medical expenses exceed 10% of the taxpayer's adjusted gross income, rather than 7.5% of adjusted gross income, as provided for regular income tax purposes. The taxpayer also must add back to taxable income a number of items, including the following: any deduction claimed for interest on home equity indebtedness; miscellaneous itemized deductions, and the itemized deductions claimed for state, local, and foreign real property and income taxes and for state and local personal property taxes that were claimed in determining taxable income; the standard deduction and the deductions for personal exemptions; deductions claimed for certain losses from tax-shelter farming and passive activity losses; and the difference between the fair market value and the amount paid for any incentive stock options exercised for the year. The tax preference items that must be added back to taxable income include depletion, intangible drilling costs, and tax-exempt interest.

The AMT was enacted to ensure that high-income taxpayers did not escape the income tax through use of the many tax incentives

207. The adjustments and "add-back" items discussed infra, notes 217-227 and the accompanying text do not constitute a comprehensive list of all of the adjustments and tax preference items under the AMT. The discussion is intended to provide a general understanding of the application of the AMT.
provided in the Internal Revenue Code.\textsuperscript{219} Congress enacted the predecessor of the AMT after hearing testimony by former Treasury Secretary Joseph Barr that in 1967, 155 individual taxpayers with adjusted gross incomes over $200,000 paid no income tax.\textsuperscript{220} It also was reported that in 1964, over 1,100 individual federal income tax returns reporting adjusted gross income in excess of $200,000 reported an average tax liability that equalled only 22% of economic income.\textsuperscript{221} These reports raised concern that perceived abuses of the tax system by wealthy taxpayers would erode tax compliance by other taxpayers.\textsuperscript{222}

The Internal Revenue Code contains many tax incentives designed to encourage behavior or activities that Congress regards as economically desirable.\textsuperscript{223} In the 1950's, scholars began to criticize such incentives because they kept the tax base from matching economic income and created inequities for low-income taxpayers who could not afford to make the investments that received tax-favored treatment.\textsuperscript{224}

Congress did not want to eliminate the tax incentives provided in the Code. Instead, Congress enacted the AMT to ensure that wealthy taxpayers did not avoid income taxes altogether by taking advantage of too many of the tax incentives. The AMT, however, adds a great deal of complexity to the Code. Taxpayers must compute their income tax liability twice, once under the regular income tax provisions, and a second time under the AMT provisions, to


\textsuperscript{222} Karlinsky, \textit{supra} note 228, at 140-41.

\textsuperscript{223} Examples of such incentives include the exemption for interest received from certain municipal bonds under Section 103(a) (designed to reduce the rate of interest paid by state and local governments on debt financing by making the cost of the interest paid tax-free to investors), the low-income housing tax credit under Section 42 (designed to encourage taxpayers to invest in low-income housing by increasing the after-tax return on their investment), and accelerated depreciation schedules under Section 168 (designed to encourage businesses to purchase more equipment).

determine exactly how much they owe to the federal government. Wealthy taxpayers incur additional planning expenses to enable them to take advantage of as many of the tax incentives allowed under the regular income tax provisions without losing the tax savings to the AMT.

The greatest concern raised by the AMT, however, is that because the exemption amounts are not indexed for inflation, the AMT is likely to affect middle-income taxpayers for whom the tax was not intended. The reduction in the individual income tax brackets under EGTRRA and JGTRRA are likely to pull more taxpayers into the AMT net, complicating tax compliance for many middle-income taxpayers.

The increase in the AMT exemption amounts for 2003 and 2004 was intended to prevent many taxpayers from losing the benefits of the reduction in the individual income tax rates.\textsuperscript{225} However, after 2004, the AMT exemption amounts will return to their pre-2003 levels. It has been predicted that in 2005, 65\% of married couples with two children and a combined income between $75,000 to $100,000 will be subject to the AMT.\textsuperscript{226} By 2010, the AMT is expected to affect 33 million taxpayers, or approximately one-third of all taxpayers, as compared with 1 million in 1999.\textsuperscript{227} Of these taxpayers, 52\% are expected to come from households with income of less than $100,000 who will account for 23\% of AMT revenue.\textsuperscript{228}

Moreover, because the exemption amount under JGTRRA for married taxpayers filing joint returns is not equal to twice the exemption amount for unmarried taxpayers, the AMT is likely to undermine some of the marriage penalty relief provided by JGTRRA even in 2003 and 2004.\textsuperscript{229} Many of the problems under the AMT result from the fact that the AMT affects taxpayers who do not engage in tax shelters. Under the AMT, taxpayers may not deduct the standard deduction,\textsuperscript{230} the exemption amounts for themselves and


\textsuperscript{226} Mary Dalrymple, \textit{Alternative Minimum Tax Causing Maximum Stress}, The Advocate (Baton Rouge) (Feb. 8, 2004), at 21.


\textsuperscript{228} Id.

\textsuperscript{229} For some examples illustrating the marriage penalty under the AMT for taxpayers filing 2003 federal income tax returns, see William Stevenson, \textit{Unexpected Results: AMT and More}, 100 Tax Notes 564 (July 28, 2003).

\textsuperscript{230} I.R.C. §§ 56(b)(1)(E), 63(c) (2003).
their dependents, and state and local taxes. As a result of these disallowances, together with the marriage penalty under the AMT, married couples with two or more children who live in states that impose high taxes are likely to be subject to the AMT. It has been projected that by 2010, 97% of married couples with adjusted gross income between $75,000 and $100,000 (in 2002 dollars) will be affected by the AMT, as compared with one% in 2003.

H. State Aid

JGTRRA provides $20 billion in state aid for fiscal years 2003 and 2004, with one-half for Medicaid assistance, and one-half available for other government services. The Medicaid assistance is achieved by increasing the proportion of total program costs in each state that is paid by the federal government. The remaining $10 billion in state aid ($5 billion for the federal fiscal year 2003 and $5 billion for the federal fiscal year 2004) will be distributed to the states to use for essential government services or to comply with unfunded federal mandates.

The $20 billion in state aid was intended to help states struggling with budget deficits. The $20 billion in state aid is only temporary. After June 2004, no further funding will be provided to the states unless Congress decides otherwise.

II. ECONOMIC CRITIQUE OF JGTRRA

Several economists have offered significant criticism of JGTRRA. While JGTRRA’s tax cuts provide short-term stimulus

231. Id.
233. Burman, supra note 236, at 110.
to the economy, they threaten to burden the country with long-term deficits. Federal deficits are likely to make borrowing more expensive, raising interest rates\(^2\) and causing the economy to contract.\(^3\) The additional interest due on the federal debt is likely to hinder future discretionary spending by Congress for needed programs.

Indeed, with the current fiscal burdens of the war in Iraq, operations in Afghanistan, and increased spending on homeland security, the country is, as of this writing, facing record deficits. The nearing retirement of 77 million baby boomers threatens to increase deficits even further.\(^4\) The Joint Committee on Taxation has released a report that indicates that the economic problems resulting from the deficits created by JGTRRA will far outweigh any short-term stimulus that the Act may provide.\(^5\)

In February 2004, President Bush presented Congress with a budget that forecasts a deficit of $521 billion.\(^6\) 30% of the deficit has been attributed to tax cuts.\(^7\) Indeed, a report issued by a team of economists from the International Monetary Fund has questioned the wisdom of the tax cuts and warned that the large deficits in the United States pose significant risks, not only for the United States, but for the global economy.\(^8\) Leonard Burman, William Gale, and Peter Orszag, co-directors of the Tax Policy Center have explained:

In the long run, economic growth reflects expansions in the capacity to produce goods and services. Tax cuts can increase

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241. The 77 million soon-to-retire baby boomers was a concern expressed by Federal Reserve Chairman Alan Greenspan in delivering the Federal Reserve Board’s twice-a-year economic report to Congress on February 11, 2004. For a summary of the report, see Jeannine Aversa, Greenspan Cites Gains, Fears Deficits, The Advocate (Baton Rouge) (Feb. 12, 2004), B1, B2.


244. Robert J. Samuelson, Budget Can Be Balanced; No One Cares, The Advocate (Baton Rouge) (Feb. 12, 2004), at 9B. Some have estimated that the tax cuts are responsible for nearly 32% of a projected $897 billion deficit. John D. McKinnon, U.S. Revenue Springs a Leak, Wall St. J. (Feb. 11, 2004), at A4.

economic growth by providing incentives to raise the level, and improve the allocation of labor supply, saving and investment. But tax cuts can reduce long-term growth by raising after-tax income (which discourages work) and by providing windfall gains (which encourages consumption rather than saving), and by reducing public and national saving.\footnote{246}

JGTRRA also has been criticized because it is regressive, offering much larger benefits to wealthy taxpayers than low-income individuals.\footnote{247} The federal income tax historically has been a progressive tax, providing higher rates on increasing increments of income.\footnote{248} The theory behind a progressive rate structure is based on the ability to pay. The marginal utility of money decreases as incomes increase because low-income taxpayers must spend a greater proportion of their income on necessities than high-income taxpayers.

The degree of progressivity in the federal income tax has varied from year to year.\footnote{249} While commentators generally do not disagree that taxes should be progressive, they disagree as to the degree of progressivity that should be provided by the federal income tax.\footnote{250}

A flat tax superficially seems to be a more “fair” tax than a progressive tax structure because under a flat tax, all taxpayers pay the same proportional amount of their income to the federal government. However, a flat tax loses much of its appeal (at least to this author) when the relative burdens on high- and low-income taxpayers are compared. For example, assume that the federal government imposes a flat tax of 25% on all of the taxable income earned by an individual during 2004. Under a flat tax, no deductions would be allowed for personal expenses. A taxpayer with $10,000 of income would pay $2,500 in federal income tax, leaving the taxpayer

\footnote{246. Burman, Gale & Orszag, supra note 5, at 1084.}
\footnote{247. See, e.g., id. at 1088-91.}
\footnote{248. See I.R.C. § 1(a)-(e), (i) (2003) (increasing amounts of an individual’s ordinary income (so-called “tax brackets”) taxed at rates of 10, 15, 25, 28, 33 and 35%).}
\footnote{249. For example, from 1993 until 2001, the rate brackets that applied to an individual’s ordinary income were 15, 28, 31, 36, and 39.6%. I.R.C. § 1(a)-(e) (2003). The pre-2001 rate schedule was more progressive than the rate schedule under JGTRRA because high-income taxpayers paid taxes at significantly higher rates than low-income taxpayers.}
with $7,500 of after-tax income, hardly enough to meet the cost of living. (In 2002, the poverty threshold for a family of four was $18,392 in annual income, the poverty threshold for a family of three was $14,348, and the poverty threshold for unrelated individuals was $9,183).\footnote{251} In contrast, a taxpayer with $1 million of taxable income would pay $250,000 in federal income tax, leaving the taxpayer with $750,000 of after-tax income.

Messrs. Burman, Gale, and Orszag have estimated that acceleration of the EGTRRA tax cuts (and the accompanying AMT changes) would increase after-tax income by 3\% for households with income above $1 million, compared to an average of 0.5\% for the 85\% of households with income below $75,000.\footnote{252} In other words, taxpayers with income over $1 million would enjoy an average reduction in taxes of $64,000, whereas those with incomes below $75,000 would experience an average reduction in taxes of $209.\footnote{253} Not only does the distributional imbalance of the JGTRRA tax cuts raise equity issues, but Messrs. Burman, Gale, and Orszag predict that it is not likely to produce a serious boost to the economy.\footnote{254} Higher-income taxpayers are less likely to spend additional after-tax income on immediate consumption needs than taxpayers living from paycheck to paycheck.

Indeed, the reduction in the highest federal income tax rate is not likely to help small businesses. Most small business owners are in low-income tax brackets.\footnote{255} Only 2\% of small business owners are in the highest income tax bracket.\footnote{256}

The tax cuts under JGTRRA are likely to increase consumer spending. Some economists have noted that while consumer spending remained strong during most of the economic downturn, the real problem in the downturn was a result of a slowdown in capital spending by businesses.\footnote{257} The 50\% bonus depreciation and the increase in Section 179 expensing under JGTRRA may encourage businesses to increase investments in equipment.

However, most business owners will not be able to invest in new equipment unless they can finance their purchases through borrowing. Indeed, the low interest rates maintained by the Federal Reserve Board failed to increase capital spending by businesses. Some have

\begin{footnotes}
\footnote{252}{Burman, Gale & Orszag, supra note 5, at 1092.}
\footnote{253}{Id.}
\footnote{254}{Id.}
\footnote{255}{Id. at 1093.}
\footnote{256}{Id.}
\footnote{257}{Metcalf, supra note 247.}
\end{footnotes}
opined that businesses have not been spending much on equipment because they have excess capacity and because banks are leery of lending to companies that are not credit-worthy. Thus, it is uncertain whether the tax incentives for business investment will actually have much of an effect on the economy. Even if businesses purchase more equipment in 2003, 2004, and/or 2005, there is a risk that when the incentives expire, capital spending by businesses will drop once again as a result of excess capacity, creating an additional drain on the economy in the long term.

Economists also have criticized the reduction in the tax rates on capital gains rates and dividends. Like the reduction in the high-bracket income tax rates on ordinary income, the reduction in the rates on capital gains and dividends is regressive, offering the greatest benefits to wealthy taxpayers. It is likely that rate reductions on capital gains and dividends have, as of this writing, given a boost to the stock market. On May 5, 2003, the Dow Jones Industrial Average stock index (the “Dow”) closed at 8531.57. On February 10, 2004, the Dow closed at 10,613.85.

Nevertheless, it has been observed that higher stock prices increase consumer spending and reduce savings, thereby reducing future national income. Thus, it is not certain whether the current rise in the stock market is a blessing or a curse, especially if it increases private debt, providing no national savings to offset the large projected federal deficits.

Moreover, reducing the rate of tax on capital gains is an inefficient way to boost the stock market and will create a serious drain on federal revenues. The capital gains reductions apply to investments other than stock. It has been estimated that one-half of all capital gains are the result of sales of assets other than corporate stock. The greatest concern about the reduction in the capital gains rates, however, is that it is likely to create a wave of tax shelters for corporations and individuals. Because the preferential rates on capital gains apply to only certain types of income and the characterization of income as capital gain, rather than ordinary income, often turns on the structure of a transaction, a staggering amount of time has been spent converting ordinary income to capital gains.

258. Id.
262. Burman, Gale & Orszag, supra note 5, at 1087–88; Mortgage Bankers, supra note 248.
263. Burman, Gale & Orszag, supra note 5, at 1095.
264. Id.
JGTRRA increases the incentive to engage in such activities by reducing the maximum rate on adjusted net capital gain to 15%, as opposed to the 35% maximum rate on ordinary income.

JGTRRA includes a few provisions that, if there were no concern about the federal deficit, might be worth implementing. At least one economist has praised JGTRRA's increase in the Section 179 expensing allowance because it provides tax simplification. Section 179 allows taxpayers to deduct most, if not the full cost, of assets, rather than reporting annual depreciation using complicated depreciation schedules.

It also has been noted that the expansion of the 10- and 15% income tax brackets for married couples and the child tax credit provide some progressivity to the Internal Revenue Code by reducing the tax liability of low- and middle-income taxpayers and offsetting some of the regressive payroll and self-employment taxes (sometimes collectively referred to as "social security taxes"). The tax rate reductions and the increase in the child tax credit under JGTRRA, however, provide little progressivity for unmarried taxpayers with no children.

To better appreciate the regressivity of the social security taxes, it is useful to review the manner in which they operate in tandem with the federal income tax. The payroll tax under the Federal Insurance Contributions Act ("FICA") and the self-employment tax under the Self Employment Contributions Act ("SECA") apply, in addition to the federal income tax.

The social security taxes consist of two components; (1) old-age survivors and disability insurance (OASDI); and (2) hospital insurance ("HI"). Under FICA, an employer and an employee each pay a tax at a rate of 6.2% of the total wages for the OASDI portion of the tax, and tax at a rate of 1.45% of total wages for the HI portion of the tax. Under SECA, a self-employed individual pays a tax at a rate of 12.4% on the individual's self-employment income for the OASDI component of the tax, and tax at a rate of 2.9% on the individual's self-employment income for the HI component of the tax.
tax. There is a limit, however, on the total amount of wages and self-employment income subject to the OASDI component of the FICA and SECA taxes, computed as an amount equal to the contribution and benefit base ("contribution base") as determined under Section 230 of the Social Security Act during the taxable year. For 2004, the contribution base is $87,900.

Thus, in 2004, the OASDI component, which is the largest portion, of the social security taxes does not apply to an individual's total self-employment income and wages in excess of $87,900. Because the social security taxes apply in addition to the federal income tax, the self-employment tax and the payroll tax increase the effective tax rates on self-employment income and wages up to $87,900 (in 2004), significantly more than the effective tax rates on such income in excess of $87,900.

Example #12: Assume that Sam is a single taxpayer with no children and has $60,000 of income from self-employment in 2004 and has no expenses that are deductible in determining adjusted gross income other than one-half of his liability for 2004 self-employment taxes. Sam owes $9,180 in self-employment taxes (15.3% of $60,000 income from self-employment). If Sam uses the standard deduction, rather than claiming itemized deductions, Sam's 2004 federal income tax liability is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-Employment Income</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less, one-half of $9,180 self-employment tax</td>
<td>($4,590)</td>
</tr>
<tr>
<td>Less, the Standard Deduction</td>
<td>($4,850)</td>
</tr>
<tr>
<td>Less, the Exemption Amount</td>
<td>($3,100)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$47,460</td>
</tr>
<tr>
<td>Tax Liability</td>
<td>$8,602.50</td>
</tr>
</tbody>
</table>

Thus Sam owes a total of $17,782.50 ($9,180, plus $8,602.50) in self employment and federal income taxes for 2004. The effective rate of tax that Sam pays on his $47,460 of taxable income is 37.5% ($17,782.50/$47,460).

277. Sam's $8,602.50 federal income tax liability is computed by reference to Rev. Proc. 2003–85 § 3.01 Table 3, 2003–49 I.R.B. 1184, as $4,000, plus $4,602.50 (25% of $18,410 ($47,460 - $29,050)).
Example #13: Betty is a single taxpayer with no children and has $400,000 of self-employment income in 2004. Assume that Betty has no expenses that are deductible in computing adjusted gross income for 2004, other than one-half of her self-employment tax liability. The amount of Betty’s liability for self-employment tax on her $400,000 of income from self-employment is $22,499.60, determined as follows:

$13,448.70 (15.3% combined OASDI and HI components of the self-employment tax on the first $87,900 of self-employment income), plus

$9,050.90 (2.9% HI component of the self employment tax on $312,100 ($400,000 self-employment income - $87,900)).

If Betty claims the standard deduction, rather than itemizing her deductions, in 2004, her 2004 federal income tax liability is computed as follows:

Self-Employment Income ............... $400,000
Less, One-Half of the Self-Employment Tax ............... ($11,269.80)
Less, the Standard Deduction ............. ($4,850)
Less, one Exemption .................. ($3,100)
Taxable Income .................. $380,780.20

Tax Liability .................. $114,180.57

The effective federal income tax rate on Betty’s $380,780.20 of taxable income is 30% ($114,181/$380,780).

Betty’s combined liability for self-employment and federal income taxes is $127,669.27 ($114,180.57, plus $13,488.70). The effective total tax rate on Betty’s

278. See I.R.C. § 164(f) (2003) (allowing a taxpayer to deduct one-half of the taxpayer’s self-employment taxes for the taxable year in computing adjusted gross income).

279. The $114,180.57 federal income tax liability is determined by reference to Rev. Proc. 2003–85 § 3.01 Table 3, 2003–49 I.R.B. 1184, as follows. For taxable income over $319,100, the tax is $92,592.50, plus $21,588.07 (35% of $61,680.20 ($380,780.20 - $319,100)).
$380,780 of taxable income is 33.5% ($127,669/$380,780).

Examples #12 and #13 illustrate the regressivity caused by the self-employment tax. Sam, who only has $47,460 of taxable income pays total taxes at a rate of 37.5%, whereas Betty, with taxable income of $380,780 (approximately eight times the amount of Sam’s taxable income) pays total taxes at an effective rate of 30%. The following examples illustrate the regressivity of the payroll tax.

**Example #14:** Assume the same facts as in Example #12, except that Sam is an employee and has $60,000 of wages in 2004. Sam’s share of the FICA taxes on his $60,000 of wages in 2004 is $4,590 (7.65% of $60,000) Sam’s federal income tax liability for 2004 is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Gross Income</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less the Standard Deduction</td>
<td>($4,850)</td>
</tr>
<tr>
<td>Less One Exemption</td>
<td>($3,100)</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td>$52,050</td>
</tr>
<tr>
<td>Federal Income Tax Liability</td>
<td>$9,750</td>
</tr>
</tbody>
</table>

Sam’s combined FICA and federal income tax liability for 2004 is $14,340 ($4,590, plus $9,750). Thus, the effective rate of tax on Sam’s $52,050 of taxable income is 27.5% ($14,340/$52,050).

**Example #15:** Assume the same facts as in Example #13, except that Betty is an employee, and her salary for 2004 totals $400,000. Betty’s $11,249.80 share of the FICA tax liability is computed as follows:

\[
\begin{align*}
\text{FICA Tax Liability} &= \text{combined OASDI and HI components} \\
&= \text{first $87,900 (7.65%) of Betty's $400,000} \\
&= \text{excess of $87,900 ($400,000 - $87,900) (1.45%)} \\
&= \text{total of $4,525.45.}
\end{align*}
\]

280. Sam’s $9,750 federal income tax liability is computed by reference to Rev. Proc. 2003–85 § 3.01 Table 3, 2003–49 I.R.B. 1184, as follows $4,000, plus $5,750 (25% of $23,000 ($52,050 - 29,050)).
Betty’s federal income tax liability is computed as follows:

Adjusted Gross Income .................. $400,000
Less the Standard Deduction .............. ($4,850)
Less one Exemption ..................... ($3,100)

Taxable Income ....................... $392,050

Federal Income Tax Liability .......... $118,125

Betty’s total FICA and federal income tax liability for 2004 is $129,374.80 ($11,249.80, plus $118,125). Thus, Betty pays tax on her $39,250 of taxable income at an effective rate of 33%.

The regressive effects of the FICA tax are not as pronounced as the regression caused by the self-employment tax because workers are only liable for one-half of the total amount of the FICA tax due to the government. Nevertheless, they are regressive in that they tend to flatten the income tax rates. With $60,000 of wages, Sam’s highest marginal income tax bracket is 25%, whereas Betty’s $400,000 of wages cause Betty’s highest marginal income tax bracket to be 35%. The effective federal income tax rate on Sam’s $52,050 of taxable income is 19% ($9,750 federal income tax/$52,050). The FICA tax increases Sam’s effective total tax rate by 8.5 percentage points to 27.5%. In contrast, the effective federal income tax rate on Betty’s $392,050 of taxable income is 30% ($118,125 federal income tax/$392,050). The FICA tax increases Betty’s total effective tax rate by only three percentage points to 33%.

While the expansion of the 10% and 15% income tax brackets and the increased child tax credit under JGTRRA will provide some relief from these effects for married couples with children, they do nothing for single taxpayers without children. Moreover, because the social security taxes apply to wages and self-employment income of each spouse, the income tax reductions and the increased child tax credit under JGTRRA actually may not have such a significant impact on two-earner married couples. Congress could better reduce the regressivity of the social security taxes for all individual taxpayers by reforming the social security taxes, rather than relying on the income tax.

281. Betty’s $118,125 federal income tax liability for 2004 is computed by reference to Rev. Proc 2003–85 § 3.01 Table 3, 2003–49 I.R.B. 1184, as $92,592.50, plus $25,532.50 (35% of $72,950 ($392,050 - $319,100)).

Congress could have stimulated the economy in a way that created greater fairness and simplicity by enacting tax reductions providing real benefits for low- and middle-income taxpayers. Instead of the income tax rate reductions under JGTRRA, Congress should have indexed for inflation the exemption amount under the AMT. To offset revenues lost from indexing the AMT exemption amount, Congress could have reformed the social security tax system by reducing the rate of the OASDI component of the taxes and having the OASDI component apply to all wages and self-employment income.

III. CONCLUSION

JGTRRA has provided some short-term stimulus to the economy, especially to the stock market, as intended. Nevertheless, JGTRRA, to date, has failed to produce many new jobs as was promised. In February 2003, the Labor Department announced that the unemployment rate fell to 5.6% in January 2004, a two-year low, from 5.7% in December 2003. However, it was reported that non-farm jobs rose only by 112,000, well below the 150,000 to 200,000 needed to keep up with population growth. From August 2003 through January 2004, payroll growth averaged 57,000 jobs a month, as compared with 215,000 jobs a month at a comparable point after the 1990-1991 recession.

If job growth continues to stagnate, the stimulus predicted when JGTRRA was enacted may not materialize. At the same time, deficits that could have been reduced are exacerbated by the JGTRRA tax cuts. In February 2004, President Bush submitted a budget to Congress that projected a record $521 billion deficit. The tax cuts, along with stagnant job growth, threaten social security and Medicare benefits upon which many workers have been relying.

The long-term economic contraction that is likely to result from the JGTRRA tax cuts will far outweigh any short-term benefits created by the Act. Because the greatest proportion of the benefits of the JGTRRA tax cuts are and will be enjoyed by high-income taxpayers, the Act is likely to provide less stimulus to the economy than if Congress had provided greater tax cuts to low- and middle-income taxpayers who generally spend more of their income than wealthy taxpayers. Congress should repeal many, if not all, of the tax reductions under EGTRRA and JGTRRA as soon as possible to protect the future of the American economy.

284. Id.
285. Id.