TECHNICAL EXPLANATION OF H.R. 6081, THE "HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008," AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON MAY 20, 2008

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," as scheduled for consideration by the House of Representatives on May 20, 2008.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on May 20, 2008* (JCX-44-08), May 20, 2008.

TITLE I – BENEFITS FOR MILITARY

A. Recovery Rebate Provided for Military Families (sec. 101 of the bill and sec. 6428 of the Code)

Present Law

In general

Present law includes a recovery rebate credit for 2008 which is refundable. The credit mechanism (and the issuance of checks described below) is intended to deliver an expedited fiscal stimulus to the economy.

The credit is computed with two components in the following manner.

Basic credit

Eligible individuals receive a basic credit (for the first taxable year beginning) in 2008 equal to the greater of the following:

- Net income tax liability not to exceed $600 ($1,200 in the case of a joint return).
- $300 ($600 in the case of a joint return) if: (1) the eligible individual has qualifying income of at least $3,000; or (2) the eligible individual has a net income tax liability of at least $1 and gross income greater than the sum of the applicable basic standard deduction amount and one personal exemption (two personal exemptions for a joint return).

An eligible individual is any individual other than: (1) a nonresident alien; (2) an estate or trust; or (3) a dependent.

For these purposes, "net income tax liability" means the excess of the sum of the individual's regular tax liability and alternative minimum tax over the sum of all nonrefundable credits (other than the child credit). Net income tax liability as determined for these purposes is not reduced by the credit added by this provision or any credit which is refundable under present law.

Qualifying income is the sum of the eligible individual's: (a) earned income; (b) Social Security benefits (within the meaning of sec. 86(d)); and (c) veteran's payments (under Chapters 11, 13, or 15 of title 38 of the U. S. Code). The definition of earned income has the same meaning as used in the earned income credit except that it includes certain combat pay and does not include net earnings from self-employment which are not taken into account in computing taxable income.

Qualifying child credit

If an individual is eligible for any amount of the basic credit the individual also may be eligible for a qualifying child credit. The qualifying child credit equals $300 for each qualifying child of such individual. For these purposes, the child credit definition of qualifying child applies.

Limitation based on adjusted gross income

The amount of the credit (i.e., the sum of the amounts of the basic credit and the qualifying child credit) is phased out at a rate of five percent of adjusted gross income above certain income levels. The beginning point of this phase-out range is $75,000 of adjusted gross income ($150,000 in the case of joint returns).

Rebate checks

Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury. The amount of the payment is computed in the same manner as the credit, except that it is done on the basis of tax returns filed for 2007 (instead of 2008).

In no event may the Department of the Treasury issue checks after December 31, 2008. Payment of the credit (or the check) is treated, for all purposes of the Code, as a payment of tax. Any resulting overpayment under this provision is subject to the refund offset provisions, such as those applicable to past-due child support under section 6402 of the Code.

Valid identification numbers

No credit is allowed to an individual who does not include a valid identification number on the individual's income tax return. In the case of a joint return which does not include valid identification numbers for both spouses, no credit is allowed. In addition, a child shall not be taken into account in determining the amount of the credit if a valid identification number for the child is not included on the return. For this purpose, a valid identification number means a Social Security number issued to an individual by the Social Security Administration. A taxpayer identification number issued by the Internal Revenue Service (the "IRS") is not a valid identification number for purposes of this credit (e.g., an ITIN).

If an individual fails to provide a valid identification number, the omission is treated as a mathematical or clerical error. As under present law, the IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and given 60 days to request that the IRS abate its assessment.

Explanation of Provision

The provision makes a modification to the rules relating to valid identification numbers in the case of the recovery rebate credit.

The provision provides that the identification number requirement does not apply in the case of a joint return where at least one spouse is a member of the Armed Forces of the United States[2] at any time during the taxable year.

Effective Date

The provision is effective as if included in the amendments made by section 101 of the Economic Stimulus Act of 2008 (Pub. L. No. 110-185).

[2] The term includes all regular and reserve components of the uniformed services. See section 7701(a)(15).

B. Make Permanent the Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit (sec. 102 of the bill and secs. 32 and 112 of the Code)

Present Law

In general

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone may be excluded from gross income. In addition, for up to two years following service in a combat zone, military personnel may also exclude compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the combat zone.

Child credit

Combat pay that is otherwise excluded from gross income under section 112 is treated as earned income which is taken into account in computing taxable income for purposes of calculating the refundable portion of the child credit.

Earned income credit

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after the date of enactment and before January 1, 2008.

Explanation of Proposal

The provision permanently extends the availability of the election to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the Earned Income Credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

C. Modification of Qualified Mortgage Bond Program Rules for Veterans (sec. 103 of the bill and sec. 143 of the Code)

Present Law

In general

Private activity bonds are bonds that are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of qualified private activity bonds includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

Under a special rule, qualified mortgage bonds may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement. Present-law income and purchase price limitations apply to loans to veterans financed with the proceeds of qualified mortgage bonds. Veterans are eligible for the exception from the first-time homebuyer requirement without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty. However, veterans may only use the exception one time and the exception only applies to financing provided from bonds issued before January 1, 2008.

Qualified veterans mortgage bonds

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

In the case of qualified veterans' mortgage bonds issued by California or Texas, mortgage loans only can be made to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service. In the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, mortgage loans can be made to veterans who apply for financing before the date 25 years after the last date on which such veteran left active service, without regard to the calendar year the veteran served on active duty.

The annual volume of qualified veterans' mortgage bonds that can be issued in California or Texas is based on the average amount of bonds issued in the respective State between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued in years after 2009 is $25 million. This $25 million per-State limit is phased in from 2006 through 2009 by allowing the applicable percentage of the $25 million limit. The following table provides those percentages.

Calendar Year:	Applicable Percentage is:
2006	20 percent
2007	40 percent
2008	60 percent
2009	80 percent

Unused allocation cannot be carried forward to subsequent years.

Explanation of Provision

Qualified mortgage bonds

The provision permanently extends the limited exception from the first-time homebuyer rule for veterans under the qualified mortgage bond program.

Qualified veterans' mortgage bonds

The provision increases the annual limit on qualified veterans' mortgage bonds that can be issued in Alaska, Oregon, and Wisconsin in years after 2009 to $100 million. For 2008 and 2009, the $100 million limit is phased in by applying the present-law applicable percentages for those years (i.e., 60 percent in 2008 and 80 percent in 2009).

With respect to qualified veterans' mortgage bonds issued in California or Texas, the provision repeals the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977 and reduces the eligibility period to 25 years (rather than 30 years) following release from military service.

Effective Date

The provision generally applies to bonds issued after December 31, 2007. In the case of any bond issued after December 31, 2007, and before the date of enactment, the eligibility period for a loan financed with qualified veterans' mortgage bonds is 30 years following release from military service.

D. Survivor and Disability Payments with Respect to Qualified Military Service (sec. 104 of the bill and secs. 401(a), 414(u), 403(b), and 457(g) of the Code)

Present Law

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"),[3] which revised and restated the Federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service. The protections provided under USERRA do not apply if the veteran is not reemployed by the veteran's civilian employer.

USERRA generally provides that for a reemployed veteran, service in the uniformed services is considered service with the employer for retirement plan vesting and benefit accrual purposes. The employer that reemploys the returning veteran is liable for funding any resulting obligation. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. Under USERRA, any such payment to the plan must be made during the period beginning with the date of reemployment and whose duration is three times the reemployed veteran's period of uniform service, not to exceed five years.

The Small Business Job Protection Act of 1996[4] added section 414(u) to the Code to provide rules regarding the interaction of the USERRA protections with generally applicable rules that govern tax qualified retirement plans. For example, section 414(u) provides that if any make-up contribution is made by an employer or employee with respect to a reemployed veteran, then such contribution is not subject to the otherwise applicable plan contribution and deduction limits for the year in which the contribution is made (such as the section 402(g) annual limit on elective deferrals, which is generally $15,500 in 2008). Such limits are instead applied for the year to which the contribution relates had the individual continued to be employed by the employer during the period of uniformed service.

Under section 414(u), a plan to which a make-up contribution is made on account of a reemployed veteran is not treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules[5] by reason of the making of such

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[3] Pub. L. No. 103-353.

[4] Pub. L. No. 104-188.

[5] These include Code sections 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), and 416.

contribution. Consequently, for purposes of applying the requirements and tests associated with these rules, make-up contributions are not taken into account either for the year in which they are made or for the year to which they relate.

In addition, section 414(u) provides for a special rule in the case of make-up contributions of salary reduction, employer matching, and after-tax employee amounts. A plan that provides for elective deferrals or employee contributions is treated as meeting the requirements of USERRA if the employer permits reemployed veterans to make additional elective deferrals or employee contributions under the plan during the period which begins on the date of reemployment and has the same length as the lesser of (1) the period of the individual's absence due to uniformed service multiplied by three or (2) five years. The employer is required to match any additional elective deferrals or employee contributions at the same rate that would have been required had the deferrals or contributions actually been made during the period of uniformed service. Additional elective deferrals, employer matching contributions, and employee contributions are treated as make-up contributions for purposes of the rule exempting such contributions from qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules described above.

Explanation of Provision

The provision adds a new tax qualification requirement for retirement plans that are qualified under section 401(a) of the Code (a “tax-qualified plan”). Under the new requirement, a tax-qualified plan must provide that, in the case of a participant who dies while performing qualified military service, the survivors of the participant must be entitled to any additional benefits (other than benefit accruals relating to the period of qualified military service) that would be provided under the plan had the participant resumed employment with the employer maintaining the plan and then terminated employment on account of death. Thus, if a plan provides for accelerated vesting, ancillary life insurance benefits, or other survivor benefits that are contingent upon a participant’s termination of employment on account of death, the plan must provide such benefits to the beneficiary of a participant who dies during qualified military service.

Under the provision, conforming amendments apply the new tax qualification requirement to section 403(b) tax-deferred annuities and eligible deferred compensation plans (described in section 457(b)) maintained by State and local governments. The provision also conditions the deduction timing rule of section 404(a)(2) (permitting contributions for the purchase of employee retirement annuities that meet certain requirements applicable to tax-qualified retirement plans to be deducted in the year of payment) on satisfaction of the new qualification requirement.

In addition, for benefit accrual purposes, the provision permits a retirement plan to treat an individual who leaves service with the plan's sponsoring employer for qualified military service, and who cannot be reemployed on account of death or disability, as if the individual had been rehired as of the day before death or disability (a “deemed rehired employee”) and then had terminated employment on the date of death or disability. In the case of a deemed rehired employee, the plan is permitted to comply fully or partially with the benefit accrual restoration provisions that would be required under section 414(u) had the individual actually been rehired.

Subject to several conditions, if a plan complies fully or partially with the benefit accrual requirements of section 414(u), the special section 414(u) rules regarding the interaction of USERRA with the otherwise applicable benefit limitation and nondiscrimination rules apply. The first condition is that all employees performing qualified military service of the employer maintaining the plan who die or become disabled must be credited with benefits on a reasonably equivalent basis. Thus, differences in credited benefits on account of different compensation levels are permissible, but complying fully with the section 414(u) benefit accrual requirements with respect to highly compensated employees and complying partially with respect to nonhighly compensated employees is not permissible. The second condition is that if the plan credits deemed rehired employees with benefits that are contingent on employee contributions or elective contributions, the plan must determine the rate of employee contributions or elective deferrals on the basis of the actual average contributions or deferrals made by the employee during the 12-month period prior to military service (or if less, the average for the actual period of service).

The provision provides rules regarding the date by which a plan must be amended to comply with the provision. In general, a plan must be amended on or before the last day of the plan year beginning on or after January 1, 2010.

Effective Date

The provision applies in the case of deaths and disabilities occurring on or after January 1, 2007.

E. Treatment of Differential Military Pay as Wages (sec. 105 of the bill and secs. 3401 and 414(u) of the Code)

Present Law

In general

In the case of an employee who is called to active duty with the United States uniformed services, some employers voluntarily agree to continue paying the level of compensation that the service member would otherwise have received from the employer during the service member's period of active duty. Such compensation is commonly referred to as "differential pay."

Wage withholding

Differential pay is not treated as wages for purposes of the Federal income tax withholding rules that apply to an employer's payment of wages. This is because the service member is treated as terminating the employment relationship with the employer that pays the differential pay upon being called for active duty.[6]

Retirement plans

Section 415 imposes limitations on the benefits that may be provided under a retirement plan that is qualified under section 401(a) (a "qualified plan"). For a defined contribution plan, section 415 limits the annual additions to a participant's account under the plan to the lesser of a dollar amount ($46,000 in 2008) or 100 percent of the participant's compensation. In the case of a defined benefit plan, section 415 generally limits the annual benefit payable under the plan to the lesser of a dollar amount ($185,000 in 2008) or 100 percent of the participant's average compensation for the participant's high three years.

Final regulations issued in 2007 generally permit a plan to treat differential pay as compensation for purposes of section 415.[7] The section 415 limitations also apply to tax deferred annuities[8] and simplified employee pensions[9] ("SEPs"). The definition of compensation in section 415 is used in limiting the amount that may be deferred under an eligible deferred compensation plan (described in section 457(b)).

Limitation on in-service distributions

Under present law, certain types of contributions to a retirement plan are subject to restrictions that generally limit distributions to a participant prior to the participant severing

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[6] See Rev. Rul. 69-136, 1969-1 C.B. 252.

[7] Treas. Reg. sec. 1.415(c)-2(e)(4), 72 Fed. Reg. 16,878 (Apr. 5, 2007).

[8] Sec. 403(b).

[9] Sec. 408(k).

employment with the employer that sponsors the plan. This limitation on in-service distributions applies to: (1) elective deferrals under a qualified cash or deferred compensation arrangement (a "section 401(k) plan"); (2) amounts attributable to a salary reduction agreement under a section 403(b) tax-sheltered annuity; (3) amounts contributed to a custodial account described in section 403(b)(7); and (4) amounts deferred under an eligible deferred compensation plan (described in section 457(b)).

USERRA

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which revised and restated the Federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service. Section 414(u) provides special rules that permit defined benefit plans and individual account plans to satisfy the requirements of USERRA. An individual account plan for this purpose is any defined contribution plan (such as a section 401(k) plan), and includes a section 403(b) tax sheltered annuity, a SEP, a qualified salary reduction arrangement under section 408(p) ("SIMPLE"), and an eligible deferred compensation plan (described in section 457(b)). Section 414(u) does not apply to a plan to which Chapter 43 of Title 38 of the United States Code does not apply.

IRA contributions

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[10] Under section 219, the total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($5,000 for 2008); or (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount. For purposes of the IRA contribution limitations, compensation includes an individual's net earnings from self employment.

Explanation of Provision

Wage withholding

The provision amends the definition of wages for purposes of the Federal income tax withholding rules applicable to an employer's payment of wages. The provision includes as wages the employer's payment of any differential wage payment to the employee. Differential wage payment is defined as any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and (2) represents all or a

[10] Secs. 408 and 408A.

portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.

Retirement plans

The provision also provides rules relating to differential wage payments (as defined for purposes of wage withholding) for purposes of a retirement plan that is subject to section 414(u). Specifically, an individual receiving a differential wage payment is required to be treated as an employee of the employer making the payment, and the differential wage payment is required to be treated as compensation. In addition, a retirement plan that is subject to section 414(u) is not treated as failing to meet certain requirements relating to minimum participation and nondiscrimination standards[11] by reason of any contribution or benefit that is based on the differential wage payment if all of the sponsoring employer's employees: (1) are entitled to differential wage payments on reasonably equivalent terms; and (2) if all employees eligible to participate in a retirement plan maintained by the employer are entitled to make contributions based on such differential payments on reasonably equivalent terms.

Under the provision, an individual is treated as having been severed from employment during any period the individual is performing service in the uniformed services while on active duty for a period of more than 30 days for purposes of the limitation on in-service distributions with respect to: (1) elective deferrals under a section 401(k) plan; (2) amounts attributable to a salary reduction agreement under a section 403(b) tax-sheltered annuity; (3) amounts contributed to a custodial account described in section 403(b)(7); and (4) amounts deferred under an eligible deferred compensation plan (described in section 457(b)). Thus, such individuals are not prohibited from receiving distributions on account of not severing employment. However, if any amounts are distributed on account of the foregoing rule, the individual is not permitted to make elective deferrals or employee contributions to the plan during the six-month period beginning on the date of distribution.

IRAs

For purposes of the limitation on contributions to an IRA, the provision amends the term "compensation" to include differential wage payments (as defined for purposes of wage withholding).

[11] These standards include the following: section 401(a)(4) (prohibiting discrimination in contributions or benefits provided under qualified plans); section 401(a)(26) (providing minimum participation rules for qualified defined benefit plans); section 401(k)(3), (11), and (12) (providing non-discrimination rules for elective deferrals under qualified cash or deferred arrangements); section 401(m) (providing non-discrimination rules for employee contributions and employer matching contributions to qualified plans); 403(b)(12) (providing non-discrimination rules for section 403(b) tax sheltered annuities); section 408(k)(3), (k)(6), and (p) (providing non-discrimination rules for SEPs and SIMPLEs); section 410(b) (providing minimum coverage rules for qualified plans); and section 416 (requiring minimum benefits in the case of top heavy qualified plans).

Plan amendment timing

In general, the provision permits a plan or annuity contract to be retroactively amended to comply with the provision provided that the amendment is made no later than the last day of the first plan year beginning on or after January 1, 2010. Subject to certain conditions, a plan or annuity contract is treated as being operated in accordance with its terms during the period prior to amendment and, except as provided by the Secretary of the Treasury, the plan or annuity contract does not fail to meet the requirements of the Code or the Employee Retirement Income Security Act of 1974 by reason of the amendment.

Effective Date

For purposes of the wage withholding rules, the provision is effective with respect to remuneration paid after December 31, 2008. Otherwise, the provision is effective with respect to years beginning after December 31, 2008.

F. Extension of the Statute of Limitations to File Claims for Refunds Relating to Disability Determinations by the Department of Veterans Affairs (sec. 106 of the bill and sec. 6511(d) of the Code)

Present Law

In general, a taxpayer must file a claim for credit or refund within three years of the filing of the tax return or within two years of the payment of the tax, whichever expires later (if no tax return is filed, the two-year limit applies). A claim for credit or refund that is not filed within these time periods is rejected as untimely.

Generally, military retirement benefits based on length of service are included in income, whereas veterans' benefits based on a service-connected disability are excluded from income. If an individual receives includible retirement benefits and is later retroactively determined to be eligible for service-connected disability benefits, the portion of the retirement benefits attributable to the disability is retroactively excluded from income. In that case, the individual may claim a refund of the tax paid on the retroactively excluded benefits, subject to the statute of limitations on filing a refund claim.

Explanation of Provision

The provision extends the time period for filing claims for credits or refunds for retired military personnel who receive disability determinations from the Department of Veterans Affairs (e.g., determinations after the tax return is filed). Specifically, in the case of a determination after the date of enactment, the provision extends the period for filing such a refund claim until one year after the date of the disability determination (if later than the time periods allowed under present law). The provision applies to any taxable year which begins five years before the date of the determination or thereafter. In the case of a determination after December 31, 2000, and on or before the date of enactment, the period for filing a claim for credit or refund is extended until one year after the date of enactment (if later than the time periods allowed under present law).

Effective Date

The provision is effective for claims for credits or refunds filed after the date of enactment.

G. Treatment of Distributions to Individuals Called to Active Duty for at Least 180 Days (sec. 107 of the bill and sec. 72(t) of the Code)

Present Law

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Certain amounts held in a qualified cash or deferred arrangement (a "section 401(k) plan") or in a tax-sheltered annuity (a "section 403(b) annuity") may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee.

Pursuant to amendments to section 72(t) made by the Pension Protection Act of 2006,[12] the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a section 401(k) plan, section 403(b) annuity, or certain similar arrangements, (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the United States Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A section 401(k) plan or section 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to this special repayment rule. No deduction is allowed for any contribution made under the special repayment rule.

The special rules applicable to a qualified reservist distribution apply to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007.

Explanation of Provision

The provision makes permanent the rules applicable to qualified reservist distributions to individuals ordered or called to active duty on or after December 31, 2007.

[12] Pub. L. No. 109-280.

Effective Date

The provision is effective upon enactment.

H. Authority to Disclose Return Information for Certain Veterans Programs Made Permanent (sec. 108 of the bill and sec. 6103 of the Code)

Present Law

The Code prohibits disclosure of returns and return information, except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure of certain tax information to the Department of Veterans Affairs. Disclosure is permitted to assist the Department of Veterans Affairs in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The Department of Veterans Affairs disclosure provisions do not apply after September 30, 2008.

Explanation of Provision

The provision makes permanent the authority to make disclosures to the Department of Veteran's Affairs. The provision also corrects the cross-references to Title 38.

Effective Date

The provision is effective for requests made after September 30, 2008.

I. Contributions of Military Death Gratuities to Certain Tax-Favored Accounts (sec. 109 of the bill and secs. 408A and 530 of the Code)

Present Law

Military death gratuities and SGLI

Section 1477 of Title 10 of the United States Code provides for the payment of a military death gratuity to an eligible survivor of a service member. Under Code section 134, as amended by the Military Family Tax Relief Act of 2003, the full amount of the military death gratuity is excludable from gross income. Pursuant to section 1967 of Title 38 of the United States Code, certain members of the uniformed services are automatically insured against death under the Servicemembers' Group Life Insurance ("SGLI") program. In general, life insurance proceeds are excludable from gross income under Code section 101.

Roth IRAs

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[13] In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. Contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59½, death, or disability or which is a qualified special purpose distribution. A distribution is not a qualified distribution if it is made within the five-taxable year period beginning with the taxable year for which an individual first made a contribution to a Roth IRA.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($5,000 for 2008); or (2) the amount of the individual's compensation that is includible in gross income for the year. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year.

As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2008 are: (1) for single taxpayers, $101,000 to $116,000; (2) for married taxpayers filing joint returns, $159,000 to $169,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

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[13] Traditional IRAs are described in Code section 408, and Roth IRAs in Code section 408A.

The foregoing contribution limitations generally do not apply in the case of a rollover contribution to an IRA. If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity,[14] or a governmental section 457 plan may roll over distributions from the plan or annuity into a traditional IRA. For distributions after December 31, 2007, certain taxpayers are permitted to make qualified rollover contributions from such plans or annuities into a Roth IRA (subject to inclusion in gross income of any amount that would be includible were it not part of the qualified rollover contribution).

Coverdell Education Savings Accounts

Annual contributions to a Coverdell education savings account[15] may not exceed $2,000 (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18. The maximum annual contribution that can be made to a Coverdell education savings account is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. Contributions to a Coverdell education savings account are not deductible. In general, a rollover is permitted between Coverdell education savings accounts for the benefit of the same beneficiary or member of such beneficiary's family.

In general, a distribution from a Coverdell education savings account is includible in the gross income of the distributee. However, distributions from an account are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. Contributions to a Coverdell education savings account are treated as nontaxable investment in the contract. Thus, earnings on contributions are subject to tax if amounts withdrawn from the account exceed qualified education expenses. The portion of a distribution from a Coverdell education savings account that is includible in income (i.e., the portion allocable to earnings on contributions when a distribution exceeds qualified education expenses) is generally subject to an additional 10-percent tax.

Explanation of Provision

In the case of an individual who receives a military death gratuity or SGLI payment, the provision permits the individual to contribute an amount no greater than the sum of the gratuity and SGLI payments received by the individual to a Roth IRA, notwithstanding the contributions limits that otherwise apply to contributions to Roth IRAs (e.g., the annual contribution limit and the income phase-out of the contribution dollar limit). The provision also permits such an individual to contribute the gratuity and SGLI payments that the individual receives to one or more Coverdell education savings accounts, notwithstanding the $2,000 annual contribution limit and the income phase-out of the limit that would otherwise apply. The maximum amount that can be contributed to a Roth IRA or one or more Coverdell education savings accounts in the aggregate under the provision is limited to the sum of the gratuity and SGLI payments that the individual receives.

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[14] Sec. 403(b).

[15] Coverdell education savings accounts are described in sec. 530.

The contribution of a military death gratuity or SGLI payment to a Roth IRA is treated as a qualified rollover contribution to the Roth IRA. Similarly, the contribution of a military death gratuity or SGLI payment to a Coverdell education savings account is treated as a permissible rollover to such an account. The contribution of a military death gratuity or SGLI payment to a Roth IRA or Coverdell education savings account cannot be made later than one year after the date on which the gratuity or SGLI payment is received by the individual.

In the event of a subsequent distribution from a Roth IRA that is not a qualified distribution or a distribution from a Coverdell education savings account that is not a qualified education distribution, the amount of the distribution attributable to the contribution of the military death gratuity or SGLI payment is treated as nontaxable investment in the contract.

Effective Date

The provision is generally effective with respect to payments made on account of deaths from injuries occurring on or after the date of enactment. In addition, the provision permits the contribution to a Roth IRA or a Coverdell education savings account of a military death gratuity or SGLI payment received by an individual with respect to a death from injury occurring on or after October 7, 2001, and before the date of enactment of the provision if the individual makes the contribution to the account no later than one year after the date of enactment of the provision.

J. Suspension of Five-year Period for the Exclusion of Gain on Sale of a Principal Residence by Certain Peace Corps Volunteers (sec. 110 of the bill and sec. 121(d) of the Code)

Present Law

In general

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Uniformed services and Foreign Service

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Intelligence community

Specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. The five-year period may not be extended more than 10 years.

The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

Explanation of Provision

The provision creates a new rule for Peace Corps volunteers similar to the rules applicable to the uniformed services and Foreign Service and the intelligence community. Under this new rule, an individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to volunteer service in the Peace Corps. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is serving as a Peace Corps volunteer.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

K. Employer Wage Credit for Activated Military Reservists (sec. 111 of the bill and new sec. 45P of the Code)

Present Law

In general, compensation paid by an employer to an employee is deductible by the employer under section 162(a)(1), unless the expense must be capitalized. In the case of an employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment of the difference is often referred to as “differential pay.”

Explanation of Provision

If a taxpayer qualifies as an eligible small business employer, the provision allows the taxpayer to take a credit against the taxpayer’s income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the taxpayer’s qualified employees for the taxable year.

A qualified employee of a taxpayer is a person who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made. Differential wage payments means any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed $20,000.

An eligible small business employer means, with respect to a taxable year, any taxpayer which: (1) employed on average less than 50 employees on business days during the taxable year; and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee of the taxpayer. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small business employer. The credit is not available with respect to a taxpayer who has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the United States Code).

Under the provision, no deduction may be taken for that portion of compensation which is equal to the credit. In addition, the amount of any other credit otherwise allowable under Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the Code with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee.

Under the provision, the differential wage payment credit is part of the general business credit, and thus this credit is subject to the rules applicable to business credits. For example, an unused credit generally may be carried back to the taxable year that precedes an unused credit year or carried forward to each of the 20 taxable years following the unused credit year. The credit is not allowable against a taxpayer's alternative minimum tax liability.

Effective Date

The provision is effective with respect to amounts paid after the date of enactment and before January 1, 2010.

L. Exclusion of Certain State Payments to Military Personnel (sec. 112 of the bill and sec. 134 of the Code)

Present Law

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone is excludable from gross income.[16] Military personnel may also exclude, for up to two years following service in a combat zone, compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the zone. In addition, certain qualified military benefits, including certain death gratuities and other payments, are excludable from gross income.[17] Finally, the IRS has ruled that certain bonuses paid by States to military personnel are gifts that are not includible in gross income.[18]

Description of Proposal

The proposal provides that gross income does not include State or local payments of bonuses to active or former military personnel or their dependents by reason of such personnel's service in a combat zone.

Effective Date

The proposal is effective for payments made before, on, or after the date of enactment.

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[16] Sec. 112.

[17] Sec. 134.

[18] Rev. Rul. 68-158, 1968-1 C.B. 47; Chief Counsel Advice 200708003 (Feb. 23, 2007).

M. Exclusion of Gain on Sale of a Principal Residence by Certain Employees of the Intelligence Community (sec. 113 of the bill and sec. 121 of the Code)

Present Law

In general

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Uniformed services and Foreign Service

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Intelligence community

Specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. The five-year period may not be extended more than 10 years.

The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

Explanation of Provision

The provision permanently extends the provision relating to employees of the intelligence community.

The provision repeals the requirement that members of the intelligence community must move to a duty station outside of the United States to qualify for the exclusion.

Effective Date

The provision is effective for sales and exchanges after the date of enactment.

N. Disposition of Unused Health Benefits in Flexible Spending Arrangements (sec. 114 of the bill and sec. 125 of the Code)

Present Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside of a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance (referred to as a "health FSA").

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage). If certain requirements are satisfied, contributions to a health FSA and all distributions to pay medical expenses are excludable from income and from wages for FICA tax purposes.

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[19] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[20] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule. In 2005, the IRS issued guidance allowing a grace period immediately following the end of a plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during a grace period.[21] A plan may allow benefits not used during the plan year to be used to reimburse qualified expenses incurred during the period, not to exceed two and one-half months, immediately following the end of the plan year.

Proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[22] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

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[19] Sec. 125(d).

[20] Prop. Treas. Reg. 1.125-5(c).

[21] Notice 2005-42, 2005-1 C.B. 1204; see also Prop. Treas. Reg. 1.125-1(e).

[22] Prop. Treas. Reg. 1.125-5.

Explanation of Provision

Under the provision, a plan does not fail to be treated as a cafeteria plan or health FSA merely because the plan provides for qualified reservist distributions. A qualified reservist distribution means a distribution to a participant in a health FSA of all or a portion of the participant's FSA balance if (1) the participant is a reservist called to active duty for a period of at least 180 days (or is called for an indefinite period) and (2) the distribution is made during the period beginning with the call to active duty and ending on the last day of the coverage period of the FSA that includes the date of the call to active duty.

Effective Date

The provision is effective for distributions made after date of enactment.

O. Clarification Related to the Exclusion of Certain Benefits Provided to Volunteer Firefighters and Emergency Medical Responders (sec. 115 of the bill and secs. 3121, 3306, and 3401 of the Code)

Present Law

Deduction for certain State or local taxes

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning before January 1, 2008, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes.

The otherwise allowable itemized deduction for these State or local taxes is not reduced by the amount of any reduction or rebate on account of services performed as a member of a qualified volunteer emergency response organization.

Charitable deduction for certain expenses

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3), to a Federal, State, or local governmental entity, or to certain other organizations.[23] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes.

Certain tax reductions or tax rebates provided by a State or local government

In general

Present law provides an exclusion from gross income to members of qualified volunteer emergency response organizations for: (1) any qualified State or local tax benefit; and (2) any qualified reimbursement payment. A qualified State or local tax benefit is any reduction or rebate of certain taxes provided by State or local governments on account of services performed by individuals as members of a qualified volunteer emergency response organization. These taxes are limited to State or local income taxes, State or local real property taxes, and State or local personal property taxes. A qualified reimbursement payment is a payment provided by a State or political subdivision thereof on account of reimbursement for expenses incurred in connection with the performance of services as a member of a qualified volunteer emergency

[23] Sec. 170(a), (c), and (e).

response organization. The amount of such qualified reimbursement payments is limited to $30 for each month during which the taxpayer performs such services.

A qualified volunteer emergency response organization is any volunteer organization: (1) which is organized and operated to provide firefighting or emergency medical services for persons in the State or its political subdivision; and (2) which is required (by written agreement) by the State or political subdivision to furnish firefighting or emergency medical services in such State or political subdivision.

Denial of double benefits

Present law provides that the amount of State or local taxes taken into account in determining the deduction for taxes is reduced by the amount of any qualified State or local tax benefit.

Also, present law provides that expenses paid or incurred by the taxpayer in connection with the performance of services as a member of a qualified volunteer emergency response organization is taken into account for purposes of the charitable deduction only to the extent such expenses exceed the amount of any qualified reimbursement payment excluded from income under the bill.

Sunset

The rules related to certain tax reductions or tax rebates provided by a State or local government provided to volunteer firefighters and emergency medical responders do not apply to taxable years beginning after December 31, 2010.

Explanation of Provision

The provision clarifies that any qualified State or local tax benefit and any qualified reimbursement payment excluded from gross income is not subject to social security tax or unemployment tax.

Effective Date

The provision is effective as if included in section 5 of the Mortgage Forgiveness Debt Relief Act of 2007.

TITLE II – IMPROVEMENTS IN SUPPLEMENTAL SECURITY INCOME ("SSI")

A. Ensure Equitable Treatment of Military Families Under SSI (sec. 201 of the bill)

Present Law

Section 1612(a)(2) of the Social Security Act specifies that any income not defined as earned income by Section 1612(a)(1) of the act is considered unearned income, which reduces SSI benefits more quickly than earned income.

Section SI 00830.540 of the Social Security Administration ("SSA") Programs Operations Manual System ("POMS") specifies the following regarding military compensation:

- Only military basic pay is considered earned income;
- Hostile fire pay and imminent danger pay are excluded from income;
- In deeming situations only, any other type of pay received for serving in a combat zone is excluded from income; and
- All other types of military pay are considered unearned income.

Section 1612(a)(2) of the Social Security Act specifies that in-kind support and maintenance ("ISM") is considered unearned income by the SSI program. Section 1612(a)(2)(A) of the Social Security Act states that if a person is receiving ISM then his or her SSI benefit is reduced by one-third of the SSI federal benefit rate.

Section SI 00830.540 of the POMS specifies that payments made to or for a member of the uniformed services for housing at a military facility or for privatized military housing are considered ISM by the SSI program.

Explanation of Provision

The provision expands the definition of earned income for the SSI program to include all cash remuneration paid to members of the uniformed services and not otherwise excluded by law. Hostile fire pay and imminent danger would continue to be excluded from the SSI income calculation under the provision of Section 1612(b)(20) of the Social Security Act.

The provision also codifies current policy that any payments made to or for a member of the uniformed services for housing at a military facility or for privatized military housing shall be considered as ISM by the SSI program and subject to the One-Third Reduction rule.

Effective Date

The provision is effective with respect to benefits payable for months beginning after 60 days after the date of the enactment.

B. Remove Penalties for Certain Veterans Under SSI (sec. 202 of the bill)

Present Law

Section 1612(b) of the Social Security Act provides a list of income exclusions and contains no reference to State annuities for blind, disabled, or aged veterans. 20 C.F.R. sec. 416.1121 specifies that annuities for veterans are considered unearned income by the SSI program unless excluded by law. This means such annuities generally count dollar-for-dollar against SSI benefits.

Section 1613(a) of the Social Security Act provides a list of resource exclusions and contains no reference to State annuities for blind, disabled, or aged veterans. 20 C.F.R. sec. 416.1201 specifies that any cash or liquid asset or any real or personal property that a person owns and could convert into cash is considered a resource by the SSI program unless excluded by law.

Explanation of Provision

The provision specifies that any money paid by a State to a blind, disabled, or aged veteran is excluded from the SSI income calculation. The provision also specifies that the value of any money paid by a State to such veteran shall not be counted as a resource by the SSI program in that month.

Effective Date

The provision is effective with respect to benefits payable for months beginning after 60 days after the date of the enactment.

C. Exclusion of Benefits for AmeriCorps Volunteers Under SSI (sec. 203 of the bill)

Present Law

Section 1612(b) of the Social Security Act provides a list of income exclusions and contains no reference to the AmeriCorps program. 42 U.S.C. sec. 5044(f) specifies that payments made to volunteers in programs authorized under Chapter 66 of Title 42 of the United States Code are excluded from the SSI income calculation. The AmeriCorps*VISTA program, but not the AmeriCorps program, falls under this exclusion (AmeriCorps*VISTA and AmeriCorps are different programs).

Explanation of Provision

The provision specifies that any cash or in-kind benefit paid to a participant in the AmeriCorps program is excluded from the SSI income calculation.

Effective Date

The provision is effective with respect to benefits payable for months beginning after 60 days after the date of the enactment.

TITLE III – REVENUE PROVISIONS

A. Revision of Tax Rules on Expatriation of Individuals (sec. 301 of the bill and new secs. 877A and 2801 of the Code)

Present Law

In general

Income tax

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business.

Certain special rules (sections 671-679) apply to certain trust interests deemed to be owned by the grantor or other person (a "grantor trust"). In that case, the deemed owner must include in income the items of income and deduction (and credits against tax) of the portion of such trust deemed to be owned by such person.

Except to the extent a trust is a grantor trust, a transfer of property by a U.S. person to a foreign estate or trust is treated (under section 684) by the transferor as if the property had been sold to such estate or trust. The same rule applies if a domestic trust becomes a foreign trust.

Estate tax

The estates of U.S. citizens and residents are subject to estate tax on all property, wherever located. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation).

Gift tax

U.S. citizens and residents generally are subject to gift tax on transfers by gift of any property, wherever situated. Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States), but excluding intangibles, such as stock, regardless of where they are located.

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. long-term residency, unless certain conditions are met, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax for the 10-year period at the rates applicable to U.S. citizens, but only on U.S.-source income.[24]

A "long-term resident" is a noncitizen who is a lawful permanent resident of the United States for at least eight taxable years during the period of 15 taxable years ending with the taxable year during which the individual either ceases to be a lawful permanent resident of the United States or commences to be treated as a resident of a foreign country under a tax treaty between such foreign country and the United States (and does not waive such benefits).

A former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for certain dual citizens and minors who have had no substantial contacts with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary may require.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

Estate tax rules with respect to expatriates

Special estate tax rules apply to individuals who die during a taxable year in which they are subject to the alternative tax regime. Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets. The special rules apply if, at the time of death, the former citizen or former long-term resident: (1) owns, directly or indirectly, 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote; and (2) is considered to own, directly or indirectly, more than 50 percent of (a) the total combined voting power of all classes of stock of the foreign corporation entitled to vote, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then the gross estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the individual at the time of death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of death) bears to the total fair market value of all assets owned by such foreign corporation (at the time of death).

Gift tax rules with respect to expatriates

Special gift tax rules apply to individuals who make gifts during a taxable year in which they are subject to the alternative tax regime. The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or

[24] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

residency termination. In addition, gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident are subject to gift tax, if the gift is made during the time that such person is subject to the alternative tax regime. The operative rules with respect to these gifts of closely-held foreign stock are the same as described above relating to the estate tax, except that the relevant testing and valuation date is the date of gift rather than the date of death.

Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes

An individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement to the Secretary of the Treasury in accordance with section 6039G.

Sanction for individuals subject to the individual tax regime who return to the United States for extended periods

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and, therefore, is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions to the U.S. presence rules for residency purposes[25] generally do not apply. However, for individuals with certain ties to countries other than the United States[26] and

[25] Secs. 7701(b)(3)(D), 7701(b)(5), and 7701(b)(7)(B)-(D).

[26] An individual has such a relationship to a foreign country if (1) the individual becomes a citizen or resident of the country in which the individual was born, such individual's spouse was born, or either of the individual's parents was born, and (2) the individual becomes fully liable for income tax in such country.

individuals with minimal prior physical presence in the United States,[27] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), that meets such requirements as the Secretary may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

Annual return

Former citizens and former long-term residents are required to file an annual return for each year in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate and gift tax rules.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $10,000. The $10,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

Explanation of Provision

In general

In general, the provision imposes tax on certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residency. Such individuals are subject to income tax on the net unrealized gain in their property as if the property had been sold for its fair market value on the day before the expatriation or residency termination ("mark-to-market tax"). Gain from the deemed sale is taken into account at that time without regard to other Code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code, except that the wash sale rules of section 1091 do not apply. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000. The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2008. Any gains or losses subsequently realized are to be adjusted for gains and losses taken into account under the deemed sale rules, without regard to the $600,000 exemption.

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[27] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, for purposes of this test, an individual is not treated as being present in the United States on a day if the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

The mark-to-market tax described above applies to most types of property interests held by the individual on the date of relinquishment of citizenship or termination of residency, with certain exceptions. Deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts are excepted from the mark-to-market tax but are subject to the special rules described below.

In addition, the provision imposes a transfer tax on certain transfers to U.S. persons from certain U.S. citizens who relinquished their U.S. citizenship and certain long-term U.S. residents who terminated their U.S. residency, or from their estates.

Individuals covered

The provision applies to any U.S. citizen who relinquishes citizenship and any long-term resident who terminates U.S. residency, if such individual ("covered expatriate") (1) has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or residency termination that exceeds $124,000 (as adjusted for inflation after 2004 – $139,000 in 2008[28]); (2) has a net worth of $2 million or more on such date; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.

Exceptions to an individual's classification as a covered expatriate due to (1) or (2) above (but not (3)) are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual has been a resident of the United States (under the substantial presence test of section 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15-year taxable year period ending with the taxable year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18½, provided that the individual was a resident of the United States (under the substantial presence test of section 7701(b)(1)(A)(ii)) for no more than 10 taxable years before such relinquishment.

The definition of "long-term resident" under the provision is generally the same as that under present law. As under present law, an individual is considered to terminate long-term U.S. residency when the individual ceases to be a lawful permanent resident of the United States (i.e., loses his or her green card status through revocation or has been administratively or judicially determined to have abandoned such status). Under the provision, however, an individual ceases to be treated as a lawful permanent resident of the United States for all tax purposes if such individual commences to be treated as a resident of a foreign country under a tax treaty between the United States and such foreign country, does not waive the benefits of the treaty applicable to residents of such foreign country, and notifies the Secretary of the commencement of such treatment.

[28] Rev. Proc. 2007-66, sec. 3.29, 2007-45 I.R.B. 970.

The provision provides that, for all tax purposes, a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that individual's citizenship is treated as relinquished under the following rules. An individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization. Notwithstanding the two immediately preceding sentences, relinquishment may occur earlier under Treasury regulations with respect to an individual who became at birth a citizen of the United States and of another country.

In the case of a long-term resident, the date that long-term residency is terminated is the "expatriation date." In the case of a citizen, the date that the individual relinquishes citizenship is the "expatriation date."

The foregoing rules replace the present-law rules that provide that an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes until the individual gives notice of an expatriating act or termination of residency.

If an individual who is a covered expatriate becomes subject to tax as a citizen or resident of the United States for any period beginning after the expatriation date, the individual is not treated as a covered expatriate during that period for purposes of applying the withholding rules relating to deferred compensation items, the rules relating to interests in nongrantor trusts, and the rules relating to gifts and bequests from covered expatriates. If the individual again relinquishes citizenship or terminates long-term residency (after meeting anew the requirements to become a long-term resident), the mark-to-market tax and other provisions are re-triggered with the new expatriation date.

Deferral of payment of mark-to-market tax

Under the provision, an individual may elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. Interest is charged for the period the tax is deferred at the rate normally applicable to individual underpayments. The election is irrevocable and is made on a property-by-property basis. Under the election, the deferred tax attributable to a particular property is due when the return is due for the taxable year in which the property is disposed (or, if the property is disposed of in a transaction in which gain is not recognized in whole or in part, at such other time as the Secretary may prescribe). The deferred tax attributable to a particular property is an amount which bears the same ratio to the total mark-to-market tax as the gain taken into account with respect to such property bears to the total gain taken into account for the mark-to-market tax. The deferral of the mark-to-market tax may not be extended beyond the due date of the return for the taxable year which includes the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to furnish a bond to the Secretary. The bond must be conditioned upon payment of the amount of tax due, plus interest thereon, and must be in accordance with such requirements relating to terms, conditions, form of the bond, and sureties, as may be specified by regulations. The bond must be accepted by the Secretary. Other security mechanisms, including letters of credit, are permitted provided that they meet such requirements as the Secretary may prescribe. In the event that the security provided with respect to a particular property subsequently fails to meet the requirements of these rules and the individual fails to correct such failure, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the assessment or collection of the tax.

Deferred compensation items

The provision contains special rules for interests in deferred compensation items. For purposes of the provision, a "deferred compensation item" means any interest in a plan or arrangement described in section 219(g)(5), any interest in a foreign pension plan or similar retirement arrangement or program, any item of deferred compensation, and any property, or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under section 83 or in accordance with section 83.

The plans and arrangements described in section 219(g)(5) are (i) a plan described in section 401(a), which includes a trust exempt from tax under section 501(a); (ii) an annuity plan described in section 403(a); (iii) a plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, but excluding an eligible deferred compensation plan (within the meaning of section 457(b)); (iv) an annuity contract described in section 403(b); (v) a simplified employee pension (within the meaning of section 408(k)); (vi) a simplified retirement account (within the meaning of section 408(p)); and (vii) a trust described in section 501(c)(18).

If a deferred compensation item is an eligible deferred compensation item, the payor must deduct and withhold from a "taxable payment" to the covered expatriate a tax equal to 30 percent of such taxable payment. This withholding requirement is in lieu of any withholding requirement under present law. A taxable payment is subject to withholding to the extent it would be included in gross income of the covered expatriate if such person were subject to tax as a citizen or resident of the United States. A deferred compensation item is taken into account as a payment when such item would be so includible. A deferred compensation item that is subject to the 30 percent withholding requirement is subject to tax under section 871.

If a deferred compensation item is not an eligible deferred compensation item (and is not subject to section 83), an amount equal to the present value of the covered expatriate's deferred compensation item is treated as having been received on the day before the expatriation date. In the case of a deferred compensation item that is subject to section 83, the item is treated as becoming transferable and no longer subject to a substantial risk of forfeiture on the day before the expatriation date. Appropriate adjustments shall be made to subsequent distributions to take into account the foregoing treatment. In addition, these deemed distributions are not subject to early distribution tax. For this purpose, "early distribution tax" means any increase in tax imposed under section 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4).

An "eligible deferred compensation item" means any deferred compensation item with respect to which (i) the payor is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of withholding and who meet the requirements prescribed by the Secretary to ensure compliance with the withholding requirements, and (ii) the covered expatriate notifies the payor of his status as a covered expatriate and irrevocably waives any claim of withholding reduction under any treaty with the United States.

The foregoing taxing rules regarding eligible deferred compensation items and items that are not eligible deferred compensation items do not apply to deferred compensation items to the extent attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States.

Specified tax deferred accounts

There are special rules for interests in specified tax deferred accounts. If a covered expatriate holds any interest in a specified tax deferred account on the day before the expatriation date, such covered expatriate is treated as receiving a distribution of his entire interest in such account on the day before the expatriation date. Appropriate adjustments are made for subsequent distributions to take into account this treatment. As with deferred compensation items, these deemed distributions are not subject to early distribution tax.

The term "specified tax deferred account" means an individual retirement plan (as defined in section 7701(a)(37)), a qualified tuition plan (as defined in section 529), a Coverdell education savings account (as defined in section 530), a health savings account (as defined in section 223), and an Archer MSA (as defined in section 220). However, simplified employee pensions (within the meaning of section 408(k)) and simplified retirement accounts (within the meaning of section 408(p)) of a covered expatriate are treated as deferred compensation items and not as specified tax deferred accounts.

Interests in trusts

Grantor trusts

In the case of the portion of any trust for which the covered expatriate is treated as the owner under the grantor trust provisions of the Code, as determined immediately before the expatriation date, the assets held by that portion of the trust are subject to the mark-to-market tax. If a trust that is a grantor trust immediately before the expatriation date subsequently becomes a nongrantor trust, such trust remains a grantor trust for purposes of the provision.

Nongrantor trusts

Special rules apply to trusts with respect to which the covered expatriate is a beneficiary on the day before the expatriation date. The mark-to-market tax does not apply with respect to the portion of any such trust not treated (under the grantor trust provisions of the Code) as owned by a covered expatriate immediately before the expatriation date. Instead, in the case of any direct or indirect distribution from such a portion of a trust ("nongrantor trust") to a covered expatriate, the trustee must deduct and withhold from the distribution an amount equal to 30 percent of the portion of the distribution which would be includible in the gross income of the covered expatriate if the covered expatriate continued to be subject to tax as a citizen or resident of the United States. Such portion of such distribution (that is subject to the 30 percent withholding requirement) is subject to tax under section 871. The covered expatriate is treated as having waived any right to claim any reduction in withholding under any treaty with the United States.

In addition, if the nongrantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value.

If a trust that is a nongrantor trust immediately before the expatriation date subsequently becomes a grantor trust of which a covered expatriate is treated as the owner, directly or indirectly, such conversion is treated under the provision as a distribution to such covered expatriate to the extent of the portion of the trust of which the covered expatriate is treated as the owner.

Special rules

Notwithstanding any other provision of the Code, any period for acquiring property which results in the reduction of gain recognized with respect to property disposed of by the taxpayer terminates on the day before the expatriation date. This rule applies to certain incomplete transactions such as deferred like-kind exchanges and involuntary conversions. In addition, notwithstanding any other provision of the Code, any extension of time for payment of tax ceases to apply on the day before relinquishment of citizenship or termination of residency, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary.

For purposes of determining the tax imposed under the mark-to-market tax, property that was held by an individual on the date that such individual first became a resident of the United States (within the meaning of section 7701(b)) is treated as having a basis on such date of not less than the fair market value of such property on such date. An individual may make an irrevocable election not to have this rule apply.

In the case of a domestic trust that becomes a foreign trust due to the expatriation of an individual, the general income tax rules pertaining to transfers by U.S. persons to foreign trusts (i.e., section 684) apply before the rules of the provision.

Regulatory authority

The provision authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the income tax rules of the provision.

Treatment of gifts and bequests from a former citizen or former long-term resident

Under the provision, a special transfer tax applies to certain "covered gifts or bequests" received by a U.S. citizen or resident. A covered gift or bequest is any property acquired (i) by gift directly or indirectly from an individual who is a covered expatriate at the time of such acquisition, or (ii) directly or indirectly by reason of the death of an individual who was a covered expatriate immediately before death. A covered gift or bequest, however, does not include (i) any property shown as a taxable gift on a timely filed gift tax return by the covered expatriate, (ii) any property included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely filed estate tax return of the estate of the covered expatriate, and (iii) any property with respect to which a deduction would be allowed under section 2055, 2056, 2522 or 2523, whichever is appropriate (these sections allow deductions for transfers for charitable purposes or to spouses, for purposes of determining estate and gift taxes).

The tax is calculated as the product of (i) the highest marginal rate of tax specified in the table applicable to estate tax (i.e., section 2001(c)) or, if greater, the highest marginal rate of tax specified in the table applicable to gift tax (i.e., section 2502(a)), both as in effect on the date of receipt of the covered gift or bequest; and (ii) the value of the covered gift or bequest.

The tax is imposed upon the recipient of the covered gift or bequest and is imposed on a calendar-year basis. The tax applies to a recipient of a covered gift or bequest only to the extent that the total value of covered gifts and bequests received by such recipient during a calendar year exceeds the amount in effect under section 2503(b) for that calendar year ($12,000 for 2008).[29] The tax on covered gifts and bequests is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest.

Special rules apply to the tax on covered gifts or bequests made to domestic or foreign trusts. In the case of a covered gift or bequest made to a domestic trust, the tax applies as if the trust is a U.S. citizen, and the trust is required to pay the tax. In the case of a covered gift or bequest made to a foreign trust, the tax applies to any distribution from such trust (whether from income or corpus) attributable to such covered gift or bequest to a recipient that is a U.S. citizen or resident, in the same manner as if such distribution were a covered gift or bequest. Such a recipient is entitled to deduct the amount of such tax for income tax purposes to the extent such tax is imposed on the portion of such distribution that is included in the gross income of the recipient. For purposes of these rules, a foreign trust may elect to be treated as a domestic trust. The election may not be revoked without the Secretary's consent.

Coordination with present-law alternative tax regime

Under the provision, the present-law expatriation income tax rules under section 877 do not apply with respect to a covered expatriate whose expatriation or residency termination occurs on or after the date of enactment.

[29] Rev. Proc. 2007-66, sec. 3.32(1), 2007-45 I.R.B. 970.

Information reporting

Certain information reporting requirements under the law presently applicable to former citizens and former long-term residents (sec. 6039G) also apply for purposes of the provision.

Effective Date

The provision generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment. The portion of the provision relating to covered gifts and bequests is effective for gifts and bequests received on or after the date of enactment from former citizens or former long-term residents (or the estates of such persons) whose expatriation date is on or after the date of enactment.

B. Certain Domestically Controlled Foreign Persons Performing Services Under Contract with United States Government Treated as American Employers (sec. 302 of the bill and sec. 3121 of the Code)

Present Law

In general

Under the Federal Insurance Contributions Act ("FICA"), separate taxes are imposed on every employer and employee with respect to wages paid to such employer's employees.[30] These two taxes are commonly referred to as the employer's and the employee's share of FICA. The employee's share of FICA is collected by means of payroll withholding by the employee's employer.

For both the employer and the employee's share of FICA, the tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($102,000 for 2008). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

For purposes of the employer's and employee's share of FICA, wages generally means all remuneration for employment including the cash value of all remuneration paid in a medium other than cash. However, the general definition of wages is subject to a number of special rules and exceptions.[31]

Employment for FICA purposes generally means any service of whatever nature performed by an employee for the employer (irrespective of the citizenship or residence of either) within the United States. In the case of service outside the United States, employment also includes service performed by a United States citizen or resident as an employee for an American employer. As in the case of the definition of wages, the definition of employment is also subject to a number of exceptions and special rules.[32] An American employer is defined as an employer which is: (1) the United States or any instrumentality thereof; (2) an individual who is a resident of the United States; (3) a partnership, if at least two-thirds of the partners are

[30] Secs. 3101-3128 (FICA). Sections 3501-3510 provide additional rules.

[31] Sec. 3121(a).

[32] Sec. 3121(b). For example, employment for FICA purposes includes certain service with respect to American vessels or aircrafts and also includes service that is designated as employment under an agreement entered into under section 233 of the Social Security Act.

United States residents; (4) a trust, if all of the trustees are United States residents; or (5) a corporation organized under the laws of the United States or any of the States.[33]

Section 3121(l) agreements

An American employer may enter into a voluntary agreement with the Secretary of the Treasury to extend coverage of the insurance system of Title II of the Social Security Act to service performed outside the United States in the case of certain employees. Specifically, such an agreement may be entered into with respect to employees of a foreign affiliate of the American employer who are United States citizens or residents.[34] Such an agreement is commonly referred to as a "section 3121(l) agreement", and is entered into by completing Internal Revenue Service Form 2032. A foreign affiliate for purposes of the section 3121(l) agreement is any foreign entity in which the American employer has at least a 10-percent interest.[35]

If a section 3121(l) agreement is entered into, the American employer agrees to pay the Secretary of the Treasury amounts equivalent to the employer and employee's share of FICA (including amounts equivalent to interest, additional taxes, and penalties which would be applicable) with respect to the remuneration which would be wages if the services covered by the agreement constituted employment for purposes of FICA. In addition, the American employer agrees to comply with such regulations relating to payments and reports as the Secretary of the Treasury may prescribe.[36] A section 3121(l) agreement may not be terminated with respect to a foreign affiliate after June 15, 1989.[37]

In the case of a domestic corporation, a deduction is allowed for amounts paid or incurred pursuant to a section 3121(l) agreement with respect to services performed by United States citizens employed by foreign subsidiary corporations.[38] Any reimbursement of any amount previously allowed as a deduction is included in gross income in the year received.

Totalization agreements

Under section 233 of the Social Security Act, the President of the United States is authorized to enter into agreements establishing totalization arrangements between the social security system of the United States and the social security system of a foreign country (referred

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[33] Sec. 3121(h).

[34] Sec. 3121(l).

[35] Sec. 3121(l)(6).

[36] Sec. 3121(l)(1).

[37] Sec. 3121(l)(3).

[38] Sec. 176.

to as a "totalization agreement").[39] The purposes of a totalization agreement are (1) to establish entitlement to and the amount of old-age, survivors, disability, or derivative benefits based on a combination of an individual's periods of coverage under the United States social security system and the social security system of a foreign country, and (2) to prevent imposition of employment taxes by two countries on the same wages.

For purposes of FICA, during any period in which a totalization agreement is in effect, wages paid to an individual are exempt from the employer's and employee's share of FICA to the extent such wages are subject under the agreement exclusively to the laws applicable to the foreign country's social security system.[40]

Explanation of Provision

Under the provision, a foreign person is treated as an American employer with respect to certain employees for purposes of determining whether their employment is subject to the employer's and employee's share of FICA. Specifically, a foreign person is treated as an American employer with respect to an employee of the foreign person who is performing services in connection with a contract between the United States government (or any instrumentality thereof) and any member of any domestically controlled group of entities which includes such foreign person. Thus, under the provision, service performed as an employee for such an employer outside of the United States by a United States citizen or resident in connection with such a contract is employment that is subject to FICA. A domestically controlled group of entities is a controlled group of entities the common parent of which is a domestic corporation. For this purpose, a controlled group of entities is as defined in section 1563(a)(1) except that the ownership threshold is 50 percent rather than 80 percent and certain other changes are made, including that certain partnerships may be considered members of a controlled group.

The sections 3101(c) and 3111(c) exceptions for wages not subject to FICA as a result of a totalization agreement apply under the provision. Also, this provision does not apply to any services covered by an agreement under section 3121(l). In addition, the provision does not apply to services if the employer establishes to the satisfaction of the Secretary that the remuneration paid by such employer for such services is subject to a tax imposed by a foreign country which is substantially equivalent to FICA. It is intended that a tax is substantially equivalent to FICA only if the tax is imposed on wages at a rate equivalent to at least 80 percent of the combined employer and employee rates under FICA (i.e., 15.3 percent).

The provision provides that the common parent of the domestically controlled group of entities is jointly and severally liable for the FICA taxes for which the foreign person is liable as a result of the provision. In addition, the common parent is liable for any penalty imposed on the foreign person with respect to any failure to pay the FICA taxes or any failure to file any return or statement with respect to such tax or wages subject to such tax. No deduction is allowed for any liability imposed on the common parent as a result of these joint and several liability rules.

[39] 42 U.S.C. sec. 433.

[40] Secs. 3101(c) and 3111(c).

Effective Date

The provision is effective for services performed in calendar months beginning more than 30 days after the date of enactment of the provision.

C. Minimum Failure to File Penalty
(sec. 303 of the bill and sec. 6651 of the Code)

Present Law

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.[41] An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.[42]

In the case of a failure to file a tax return within 60 days of the due date, present law imposes a minimum penalty equal to the lesser of $100 or 100 percent of the amount of tax required to be shown on the return.

Explanation of Provision

The provision increases the minimum penalty for a failure to file a tax return within 60 days of the due date to the lesser of $135 or 100 percent of the amount of tax required to be shown on the return.

Effective Date

The provision is effective for tax returns required to be filed after December 31, 2008.

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[41] Sec. 6651(a)(1).

[42] Sec. 6651(b)(1).

TITLE IV – PARITY IN THE APPLICATION OF CERTAIN LIMITS TO MENTAL HEALTH BENEFITS

A. Extension of Parity in the Application of Certain Limits to Mental Health Benefits (sec. 401 of the bill and sec. 9812(f) of the Code)

Present Law

The Code, the Employee Retirement Income Security Act of 1974 ("ERISA") and the Public Health Service Act ("PHSA") contain provisions under which group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits ("mental health parity requirements"). In the case of a group health plan which provides benefits for mental health, the mental health parity requirements do not affect the terms and conditions (including cost sharing, limits on numbers of visits or days of coverage, and requirements relating to medical necessity) relating to the amount, duration, or scope of mental health benefits under the plan, except as specifically provided in regard to parity in the imposition of aggregate lifetime limits and annual limits.

The Code imposes an excise tax on group health plans which fail to meet the mental health parity requirements. The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and in exercising reasonable diligence would not have known, that the failure existed.

The mental health parity requirements do not apply to group health plans of small employers nor do they apply if their application results in an increase in the cost under a group health plan of at least one percent. Further, the mental health parity requirements do not require group health plans to provide mental health benefits.

The Code, ERISA and PHSA mental health parity requirements expired with respect to benefits for services furnished after December 31, 2007.

Explanation of Provision

The provision extends the present-law Code excise tax for failure to comply with the mental health parity requirements for benefits for services furnished on or after the date of enactment through December 31, 2008. It also extends the ERISA and PHSA requirements through December 31, 2008.

Effective Date

The provision is effective upon the date of enactment.