



# The Growing Consensus to Improve Our Tax Code

By Harry Stein, Alexandra Thornton, and John Craig    September 2014



Center for American Progress



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# Introduction and summary

Nearly all Americans agree that the tax code needs improvement, and progressives and conservatives identify many of the same guiding principles when discussing tax reform. This report discusses some aspects of good tax policy that are endorsed on both sides and then identifies specific proposals for which consensus appears to be within reach. These areas of bipartisan agreement would raise revenue by a total of \$1.4 trillion over 10 years. Additionally, this report identifies expanding the Earned Income Tax Credit, or EITC, as an opportunity to provide bipartisan tax relief to working families that would cost the federal government \$84 billion over 10 years. (see Appendix A)

Unfortunately, rigid anti-tax ideology is preventing Congress from considering and implementing these policies. For example, Americans for Tax Reform, headed by Grover Norquist, demands that candidates and incumbents pledge to oppose any legislation that would increase taxes.<sup>1</sup> But if politicians can put this extremism aside, there are opportunities throughout the tax code to make bipartisan improvements based on the principles endorsed by both progressives and conservatives.

The ideas in this report could be implemented individually or as part of a package to advance other pressing economic priorities, such as reversing the damaging, across-the-board sequestration cuts that will otherwise return in full starting in fiscal year 2016.<sup>2</sup> Taken together, these tax policies could also lay the foundation for bipartisan comprehensive tax reform, and most of these ideas come from existing tax reform proposals. This report does not endorse any particular comprehensive approach to tax reform and recognizes that the authors of those comprehensive tax reform proposals may have differing views on the appropriate process for accomplishing tax reform.

The goal of comprehensive tax reform should not be used as an excuse to block incremental improvements to raise revenue. But even if anti-tax ideology blocks reasonable steps to raise revenue, Congress can still take limited action to improve the tax code. Some of the consensus ideas that raise revenue could be paired with a bipartisan expansion of the EITC in legislation that would have no net effect on revenue and therefore satisfy Grover Norquist's Taxpayer Protection Pledge.

As Congress searches for common ground to make our tax code work better for everyone—not just the wealthy and well connected—the ideas in this report provide a good starting point for this discussion.



# Common principles for good tax policy

It is an understatement to say that President Barack Obama found little to like in the House Republican Budget, authored by Rep. Paul Ryan (R-WI).<sup>3</sup> However, progressives and conservatives can still find broad agreement on some principles for better tax policy.

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## Simplify

President Obama's Framework for Business Tax Reform pointed out that tax preferences add complexity to the tax system, as well as substantial compliance burdens.<sup>4</sup> Similarly, the House Republican Budget states that, "The current tax code is needlessly complex" and calls for making the tax code simpler.<sup>5</sup> Taxpayers collectively spend approximately 6 billion hours each year to comply with tax laws, representing lost productivity of about \$168 billion.<sup>6</sup> A simpler tax code would be a welcome development, and progressives and conservatives can agree on the principle that the tax code should be as simple as possible.

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## Broaden the tax base

Both sides also agree that the tax base should be broadened by reducing the size and number of tax breaks that shelter income from normal tax rules. These tax breaks collectively increase federal budget deficits by more than \$1 trillion each year.<sup>7</sup> The House Republican Budget is concerned that "The large amount of tax preferences that pervade the code ends up narrowing the tax base."<sup>8</sup>

Recently, House Ways and Means Committee Chairman Dave Camp (R-MI) proposed comprehensive tax reform legislation that takes action on some of the most egregious tax loopholes. Rep. Camp points out that both Democrats and Republicans support closing what he calls "lobbyist loopholes."<sup>9</sup> These are loopholes that progressives have tried to close for years because they enable wealthy individuals and corporations to avoid paying their fair share of taxes.

Scaling back these tax preferences would have the added advantage of increasing the efficiency of the tax code, meaning that revenues are raised with less effort and cost to both taxpayers and the government. House Republicans even point out that “Many of the deductions and preferences in the system are mainly used by a relatively small class of mostly higher-income individuals,” suggesting some opportunity for consensus policies to broaden the tax base in a progressive manner.<sup>10</sup>

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### Minimize economic distortion

The third principle of good tax policy that both progressives and conservatives have articulated is that the tax code should distort the economy as little as possible, unless those distortions deliver appropriate public benefits that outweigh their costs. President Obama’s Framework for Business Tax Reform aims to “reduce distortions that hurt productivity and growth.”<sup>11</sup> Rep. Ryan says that his budget “scales back the deductions, loopholes and carve-outs that are distorting economic activity.”<sup>12</sup>

To be clear, all tax breaks distort the economy by favoring a particular choice or category of taxpayers. For example, the home mortgage interest deduction is meant to encourage homeownership; the American Opportunity Tax Credit helps students go to college; and the higher standard deduction for the blind and/or elderly supports those groups. However, absent a compelling reason to create a preference, the tax code should treat taxpayers equally.

The bipartisan tax policies that follow relate to either business income or individual income and are arranged accordingly. All can be traced back to the three common principles above.

# Business tax improvements

Of the more than \$1 trillion of expenditures in the tax code, more than \$100 billion benefit selected business interests.<sup>13</sup> Many business tax preferences violate one or more of the tax principles that lawmakers agree should guide tax policy.

Policymakers on both sides of the political aisle understand that business tax expenditures can interfere with fair competition between companies and distort business decisions for the sole purpose of avoiding taxes. Too frequently, they result in unequal treatment across related assets, industries, and transactions. Furthermore, they can affect investment decisions and lead companies to take on too much debt or make other risky decisions. Finally, as mentioned above, tax preferences complicate the tax system and add to the cost of business tax compliance.

Some tax expenditures were not created to achieve any public policy goal. Clever attorneys and accountants have exploited some of them in ways that are not consistent with Congress's original intent in enacting the tax provision in question. Others were originally intended to be narrow but grew substantially over time as circumstances changed and taxpayers found ways to take greater advantage of the tax provisions.

Many businesses and policymakers admit that the proliferation of business tax preferences is not ideal and feel that government should not pick winners and losers in the marketplace. In fact, policymakers on the left and right largely agree on which provisions represent unfair or distortionary subsidies, and their solutions to specific issues are often identical.

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## Depreciation and expensing

Major investments in income-producing assets will deliver returns to a business for more than one year, so the tax code requires businesses to deduct the cost of these assets over several years—instead of deducting the entire cost in the first year. Using

this method, the tax deduction more closely matches the income generated during the useful life of the asset. Since the value of major income-producing assets—such as a car, computer, or building—declines over time, the deduction claimed by businesses over several years for those costs is called depreciation.

In theory, tax deductions for depreciation should be spread over the useful life of the asset. However, the tax code contains many expensing and accelerated depreciation rules, whereby companies may deduct investments in assets more quickly than the asset actually depreciates. These enhanced depreciation deductions reduce a business's taxable income, thus lowering federal tax revenues and effectively subsidizing the business. Some of these special depreciation rules are designed to support small business growth or investment in particular industries. While there may be limited situations where special rules are justified, in most cases, principles of good tax policy call for minimizing the distortions caused by special depreciation rules.

Rep. Camp makes reforming depreciation rules a centerpiece of his tax legislation. Rep. Camp's bill would repeal the modified accelerated cost recovery system, or MACRS, and require companies to use rules similar to the alternative depreciation system, or ADS.<sup>14</sup> Under current law, companies can generally choose which of these systems to use. MACRS provides shorter depreciation schedules than ADS for many investments, enabling companies to deduct their costs more quickly. MACRS also allows companies to accelerate depreciation deductions on their assets by taking larger deductions initially and smaller deductions in later years.<sup>15</sup> The Joint Committee on Taxation, or JCT, estimates that repealing MACRS would raise about \$270 billion over 10 years as part of Rep. Camp's broader reform.<sup>16</sup>

TABLE 1

**Examples of subsidized investment from accelerated depreciation**

Cost recovery period in years; shorter periods give companies a tax benefit

Investment	Modified Accelerated Cost Recovery System, or MACRS	Alternative depreciation system, or ADS
Offshore oil and gas drilling	5	7.5
Oil and gas exploration	7	14
Oil refining	10	16
Oil and gas pipelines	15	22
Mining	7	10
Sugar and sugar-product manufacturing	10	18
Tobacco and tobacco-product manufacturing	7	15
Steel manufacturing	7	15
Amusement parks	7	12.5
Race horses older than 2 years old	3	12
Office furniture, fixtures, and equipment	7	10

Source: Internal Revenue Service, *Publication 946* (U.S. Department of the Treasury, 2014), Appendix B, available at <http://www.irs.gov/publications/p946/ar02.html>.

Reforming depreciation rules to promote the principle of simplification is a goal shared by progressives and conservatives alike. An earlier bipartisan tax reform bill from Sens. Ron Wyden (D-OR) and Dan Coats (R-IN) took a similar approach on depreciation reform. The Wyden-Coats legislation would eliminate depreciation deductions that exceeded those allowed under ADS rules.<sup>17</sup> Former Senate Finance Committee Chairman Max Baucus (D-MT) also focused on depreciation as part of his tax reform efforts. Sen. Baucus proposed replacing both MACRS and ADS with a new system that would more closely approximate the useful life of various assets.<sup>18</sup>

There are also other opportunities to reform depreciation and expensing rules beyond repealing MACRS. In 2013, the Center for American Progress proposed requiring businesses to deduct a portion of their advertising expenses over several years since those investments yield long-term benefits.<sup>19</sup> When expenses related to intangible assets, such as advertising, are spread out over a specified period of time in order to more closely match them with the revenue they generate, this is referred to as amortization. Under current law, all advertising expenses may be deducted in the year they are incurred. A recent report from experts at PricewaterhouseCoopers found that companies reap about two-thirds of advertising benefits in the years after ads are purchased.<sup>20</sup>

Rep. Camp’s legislation incorporates this idea by only allowing companies to deduct half of their advertising costs immediately, with the other half deducted over a 10-year period.<sup>21</sup> The JCT estimates that this would raise revenues by \$169 billion over 10 years.<sup>22</sup> Rep. Camp’s House Ways and Means Committee Republican staff argue that:

*A portion of advertising has a useful life beyond the tax year in which the expenses are incurred because a portion of advertising creates long-lived intangible assets such as brand awareness and customer loyalty, the benefits of which inure to the company for many years after the taxpayer incurs the expense.*<sup>23</sup>

Congressional tax reformers agree that depreciation schedules should be simpler—in accordance with good tax principles—and should reflect the economically useful life of investments as closely as possible. Reforming depreciation rules has the potential to raise substantial revenue in the first 10 years, although the revenue gains would be smaller in the long term because businesses would still be able to deduct the full costs of their investment, just over a longer time horizon.<sup>24</sup> Since a portion of the increased revenue from depreciation reform diminishes in the long term, policymakers should not use those short-term savings to justify a long-term corporate tax rate reduction. Economists at the JCT warn that “financing a corporate rate reduction with partial repeal of MACRS results in a macroeconomic outlook that is worse by several measures than the current law baseline.”<sup>25</sup> Instead, depreciation reform should only be used to offset temporary expenses, such as the infrastructure and education investments that President Obama linked to corporate tax reform as part of his “Grand Bargain on Jobs” proposal.<sup>26</sup>

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## Corporate jet subsidy

The corporate jet subsidy allows businesses to deduct the cost of an aircraft over five years, instead of seven, as long as it is not used for a commercial purpose.<sup>27</sup> In practice, this means that businesses are granted a larger tax benefit for jets that transport executives than airlines are given for jets that carry passengers.

In the 1986 tax reform legislation, the U.S. Department of the Treasury was granted the authority to change the timeframe for deducting costs for classes of depreciable assets, such as airplanes, after studying the economic depreciation rate of the asset class.<sup>28</sup> This authority was only exercised once, in 1988,<sup>29</sup> and then the Technical and Miscellaneous Revenue Act repealed that authority later that year.<sup>30</sup> Policy

experts have noted that this change occurred not long after the Depreciation Analysis Division announced a proposed study on the class lives of aircraft.<sup>31</sup> Consequently, this wasteful subsidy remains on the books.

Fortunately, both sides support broadening the tax base by eliminating this tax break. The president's FY 2015 budget eliminates this special rule for corporate jets, which the JCT estimates would raise \$3.8 billion over 10 years.<sup>32</sup> Rep. Camp also ends this subsidy as part of his wider reform to depreciation schedules.<sup>33</sup> But Rep. Camp singles out this particular change to depreciation rules in his executive summary, calling it one of the "lobbyist loopholes."<sup>34</sup>

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### Last-in, first-out, or LIFO, accounting

Last-in, first-out, or LIFO, is an accounting method that some businesses use to lower the profits they report for tax purposes, which in turn lowers their tax bill. When a business sells an item, its profit is the sale price minus the price paid by the business to acquire the item. When a business sells many similar items, managers can adopt accounting rules for determining which item is sold instead of keeping track of each item. The LIFO rule assumes that the item sold was the one most recently purchased by the business. Due to inflation, the most recently purchased item usually costs the most. For example, imagine that an oil company buys one barrel of oil for \$65 and then a second barrel for \$85. If the oil company then sells a barrel of oil for \$90, LIFO accounting assumes that barrel of oil was purchased for \$85, not \$65, meaning the oil company would only pay taxes on \$5 in profit.

The trick to LIFO accounting is that the items purchased by the business earlier and at lower prices are never actually sold for tax purposes, even though they are, of course, sold in real life. Those are the items for which the company would have to report the highest profits for tax purposes. The tax savings a company achieves via LIFO accounting are called the LIFO reserve.<sup>35</sup> Oil companies are major beneficiaries of LIFO accounting since they sell a lot of similar items—barrels of oil—for which the price tends to increase over time.<sup>36</sup>

Both Rep. Camp and President Obama support repealing LIFO accounting with transition rules so that companies using LIFO do not have to pay taxes on their entire LIFO reserve immediately.<sup>37</sup> Repealing LIFO accounting simplifies the tax code, consistent with a consensus principle of tax policy. First-in, first-out, or FIFO, accounting would still be permitted. This method assumes that when an

item is sold, it was the earliest one purchased instead of the most recent one. Under FIFO accounting, there are no items that are never sold for tax purposes. Repealing LIFO accounting would raise about \$106 billion over 10 years,<sup>38</sup> although some of this gain is due to a short-term revenue boost as companies pay taxes on their LIFO reserves.<sup>39</sup>

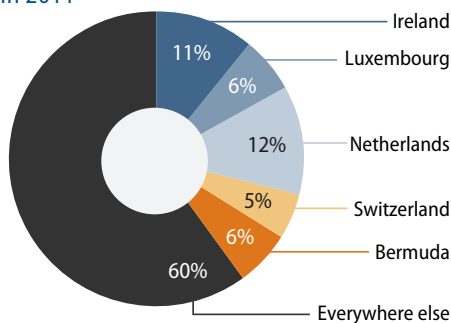
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## Earnings stripping

The United States taxes income earned by U.S. businesses under a worldwide system.<sup>40</sup> Under this system, tax is owed to the United States regardless of whether the income is earned in Alabama or Albania. However, U.S. multinational corporations are also offered the option to defer taxes owed on profits earned by their foreign subsidiaries. Taxes can be deferred on these profits until the foreign subsidiary repatriates the earnings back to their U.S. parent company.<sup>41</sup> But while those foreign profits are considered offshore for tax purposes, companies often place those profits in U.S. bank accounts, where they are able to earn interest and circulate through the U.S. economy.<sup>42</sup> The deferral of taxes on foreign corporate income is the largest tax expenditure in the corporate tax code and is projected to cost the United States more than \$80 billion per year.<sup>43</sup>

**FIGURE 1**  
**"Foreign" profits of U.S. corporations in tax havens**

Pretax foreign profits of U.S. corporations in 2011



Source: Bureau of Economic Analysis, *U.S. Direct Investment Abroad (USDIA): Preliminary 2011 Data* (U.S. Department of Commerce, 2013), table II.D.1, available at <http://www.bea.gov/international/usdia2011p.htm>.

Deferral creates an incentive to move profits to foreign subsidiaries, especially those with low corporate tax rates, in order to delay when taxes are due in the United States. While some profits may be in offshore locations for legitimate business reasons, other profits earned domestically are being artificially shifted offshore for tax purposes. This explains why 40 percent of all foreign profits for U.S. corporations in 2011 were booked in Bermuda, Switzerland, Luxembourg, Ireland, and the Netherlands.<sup>44</sup> These five countries are often referred to as tax havens because of their extremely low tax rates.<sup>45</sup>

U.S. multinationals have clever ways of stripping earnings from their U.S. books and shifting those earnings to their foreign subsidiaries. One common way to do this is by maximizing debt held in the United States. The interest on that debt can be

deducted as a business expense and thus reduce the U.S. company's taxable income. Corporations are generally allowed to borrow money in the United States to finance foreign operations and then deduct the interest costs from their U.S.



taxable income immediately, even though their foreign income is not taxed until it is brought back into the United States.<sup>46</sup>

President Obama proposes deferring interest deductions for debt connected to foreign profits until those profits are brought back to the United States and taxed.<sup>47</sup> The Joint Committee on Taxation estimates that this would raise revenues by about \$51 billion over 10 years.<sup>48</sup> Rep. Camp proposes a much more limited approach under which some interest deductions are disallowed if the corporation is excessively leveraged in the United States, meaning their U.S. interest costs exceed 40 percent of their U.S. income or their U.S. debt exceeds their worldwide debt by more than 10 percent.<sup>49</sup> This would raise revenue by \$24 billion over 10 years as part of Rep. Camp's broader tax reform.<sup>50</sup>

By preventing the loss of the underlying taxable income, both of these proposals fulfill the consensus tax policy goal of broadening the tax base by reducing tax breaks that shelter income from normal taxation and only benefit a small class of taxpayers—multinational corporations.

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## Transfer pricing

Companies can shift income away from the United States and toward low-tax jurisdictions by selling intangible property, such as copyrights or patents, to their foreign subsidiaries in lower-tax countries and then paying the foreign subsidiaries handsomely for the right to use the intangible property. The price paid by the U.S. firm is a deductible expense and is difficult for tax officials to challenge.<sup>51</sup> By setting transfer prices to maximize the tax benefits, U.S. multinational corporations can reduce their U.S. tax bills without changing the real ownership of any assets or the overall financial position of the multinational company.

The tax code contains transfer pricing rules that are supposed to prevent multinational corporations from gaming the tax system in this way. The goal of transfer pricing rules is to assure that prices paid between members of a multinational corporate group reflect what would have been bargained for between unrelated parties, known as the “arm's length principle.”<sup>52</sup>

In the case of intangibles, however, many of the tools used to assess the accuracy of pricing become less reliable and easier to evade.<sup>53</sup> First, comparable transactions between two unrelated companies do not often exist for many of the transactions

that occur within a corporate group.<sup>54</sup> As a result, government tax administrators do not have a baseline to use when determining what an arm's length transaction would have looked like. Second, the unique nature of patents, copyrights, and trademarks compounds this problem, since even the closest examples of transfers of rights between unrelated companies will involve intangible assets with significant differences.<sup>55</sup>

Rep. Camp recognized the problems with current transfer pricing rules in 2011, and one of the remedies he offered at the time was a provision in President Obama's budget called the Excess Returns Proposal.<sup>56</sup> This would immediately tax the excess profits of a foreign subsidiary if those profits are related to a transferred intangible and were taxed at a low foreign rate.<sup>57</sup> The proposal defined excess profits as gross income that exceeds 150 percent of costs.<sup>58</sup> This policy would raise about \$21 billion over 10 years.<sup>59</sup>

This is not a penalty; it simply scales back the tax benefit provided by deferral in cases when corporations are abusing this benefit. The Excess Returns Proposal only targets foreign profits that have enjoyed a low effective tax rate. The proposal would tax all excess profits if they face a foreign tax of 10 percent or less and phase out as the effective foreign tax rate approaches 15 percent.<sup>60</sup> By targeting only profits in low-tax jurisdictions, the proposal narrows its focus to the most egregious cases of transfer pricing tax avoidance.

Rep. Camp eventually chose a different option to crack down on transfer pricing tax avoidance in his comprehensive tax reform bill. Under this proposal, foreign intangible income would be taxed immediately at a reduced rate, meaning deferral rules would not apply.<sup>61</sup> Rep. Camp's bill would accomplish this by allowing companies to deduct 40 percent of this income from taxation while taxing the rest at normal rates. Taxing 60 percent of foreign intangible income at the 25 percent corporate tax rate in Rep. Camp's bill would result in an effective tax rate of 15 percent. If the corporate tax rate remained at 35 percent, the effective tax rate on foreign intangible income would be 21 percent.

Both progressives and conservatives agree that transfer prices should be as accurate as possible so that corporations pay the correct amount of tax. Both sides also agree that the current transfer pricing system often fails to properly value intangible assets transferred between corporate subsidiaries, resulting in an erosion of the U.S. tax base, and they even consider similar solutions to improve transfer pricing rules.

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## Corporate-owned life insurance

Some corporations take out life insurance policies on their employees, often to help pay for deferred compensation costs such as retirement and health care.<sup>62</sup> Life insurance policies benefit from important tax preferences, so corporate-owned life insurance reduces the tax bills of many businesses.<sup>63</sup> Those tax advantages are compounded when a business borrows money to pay for corporate-owned life insurance since the interest payments on that borrowed money are tax deductible.

Under current law, corporate interest expenses are not supposed to be deductible if the interest payments are connected to tax-advantaged life insurance policies, since the company is already benefitting from favorable tax rules for life insurance. However, an exception to this rule applies if the corporate-owned life insurance policy covers the company's directors, officers, employees, or someone who owns at least 20 percent of the business. The exception was intended to make it easier for companies to provide for succession planning—for example, when a critical executive such as the company founder dies. In such cases, employees throughout a company can be harmed, and it makes sense to facilitate business planning that insures against such unexpected events.

As it turns out, however, the exception was too broadly worded, enabling companies, especially large ones with thousands of employees, to take advantage of debt-financed life insurance investments as a tax planning tool.

These companies are effectively engaging in a practice known as “tax arbitrage,” which means they are taking advantage of differences in the way transactions are treated for tax purposes. In large companies with lots of executives and a large amount of debt, the company can effectively use non-debt-financed insurance policies, which enjoy tax preferences, to fund interest payments on debt used for other purposes, while also deducting those interest payments.

Both President Obama and Rep. Camp advocate scaling back the exception that allows companies to deduct interest payments on debt when that company also purchases life insurance. Both plans eliminate the exceptions for officers, directors, and employees.<sup>64</sup> Thus, the exception to the rule against corporations deducting interest payments on debt connected to life insurance policies would only be available for life insurance policies covering owners who hold at least 20 percent of the business. The proposal reduces economic distortion by more narrowly targeting the exception to actual business succession planning strategies.<sup>65</sup>

The JCT estimates that President Obama and Rep. Camp's proposal would raise revenues by about \$7 billion over 10 years.<sup>66</sup>

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## Bank tax

Our economy is still digging out of the worst recession since the Great Depression—a recession caused in large part by excesses within the financial sector.<sup>67</sup> At the same time, Wall Street bonuses grew 15 percent in 2013, reaching amounts not seen since 2007.<sup>68</sup> Progressives and conservatives alike are starting to realize that Wall Street is not currently paying its fair share in taxes and agree on some of the same ideas for fixing this problem.

When Congress passed the Emergency Economic Stabilization Act of 2008, commonly known as the bank bailout, it required the president to present a plan to recoup its costs from the financial sector.<sup>69</sup> President Obama fulfilled this requirement by including a Financial Crisis Responsibility Fee in his FY 2015 budget, which would apply to large financial institutions with assets exceeding \$50 billion.<sup>70</sup> The fee would increase as a financial institution's liabilities increase and would be lower for more stable sources of funding. The JCT estimates that this would raise \$48 billion over 10 years.<sup>71</sup>

Rep. Camp also advocates a new tax on big banks as part of his tax reform bill, but it differs in key respects from President Obama's plan. First, Rep. Camp calls for a higher bank tax than President Obama. The JCT estimates that Rep. Camp's bank tax would raise \$86 billion over 10 years.<sup>72</sup> Second, Rep. Camp's tax is focused on only the largest financial institutions and thus would not apply to financial institutions with less than \$500 billion in worldwide assets.<sup>73</sup>

Rep. Camp's House Ways and Means Committee Republican staff notes that, "this concept has strong bipartisan, bicameral support."<sup>74</sup> The bank tax is consistent with consensus tax principles of reducing economic distortions in that it requires big banks to mitigate the costs that may arise from the systemic risk posed by these institutions to the overall economy and the general public.

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## Mark-to-market accounting for derivatives

The financial sector has created a wide range of new products over the past 50 years to diminish the risk of loss or increase the opportunity for gain on various underlying products. These so-called “derivative” products include forwards, futures, options, and notional principal contracts, as well as convertible debt, contingent debt, structured notes, and certain securities lending transactions. The use of these financial derivatives has grown dramatically in recent years.<sup>75</sup>

The tax treatment of gains and losses on these derivatives has evolved over the years as well, and the JCT reports that inconsistent tax treatment has created opportunities for investors to use derivatives to lower their tax bill.<sup>76</sup> The tax rules for some derivatives require their owners to pay taxes each year on their gains, while other types of derivatives do not create tax obligations until they are sold.<sup>77</sup> Some derivatives also benefit from capital gains tax preferences, while others do not.<sup>78</sup> In many cases, financial institutions can construct instruments that are economically equivalent but achieve different tax planning results.

Many tax experts have called for a uniform mark-to-market standard for taxing derivatives, which means that the gain or loss on derivatives would be recognized each year for tax purposes, regardless of whether or not the derivatives are actually sold.<sup>79</sup> This would promote both the shared principle of simplification and the principle of reducing tax-motivated distortions in economic behavior. President Obama and Rep. Camp both advocate requiring mark-to-market tax treatment for derivatives, with exceptions for derivatives used specifically to hedge an actual business risk. The use of derivatives for tax avoidance is one of Rep. Camp’s “lobbyist loopholes,”<sup>80</sup> and the JCT estimates that the mark-to-market rules included in President Obama’s budget would raise \$14.3 billion over 10 years.<sup>81</sup>

The use of derivatives for tax avoidance is one of Rep. Camp’s ‘lobbyist loopholes.’

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## Executive compensation

In the 1990s, President Bill Clinton and Congress moved to rein in tax benefits for excessive executive compensation by placing a \$1 million cap on deductible compensation for a firm’s highest paid employees. Businesses are still allowed to pay their top executives as much as they choose, but annual compensation exceeding \$1 million is not tax deductible to the business. However, the \$1 million deductibility limit does not include pay that is based on performance. As a result, companies have shifted their executive compensation into performance-based forms of pay, such as stock options, which continue to be deductible. At the same time, executive compensation has continued to soar.<sup>82</sup>

According to Rep. Camp's Republican staff on the House Ways and Means Committee, shifting executive compensation to stock options and related vehicles "has led to perverse consequences as some executives focus on – and could, in rare cases, manipulate – quarterly results (off of which their compensation is determined), rather than on the long-term success of the company."<sup>83</sup> This violates the tax principle to minimize harmful economic distortions.

Rep. Camp's tax reform bill would repeal the exception for performance pay from the \$1 million limitation on tax-deductible executive compensation, so the cap would begin to cover stock options.<sup>84</sup> This provision would raise about \$12 billion over 10 years.<sup>85</sup> Senate Budget Committee Chairwoman Patty Murray (D-WA) also introduced legislation to repeal the exception for stock options,<sup>86</sup> as have Sens. Jack Reed (D-RI) and Richard Blumenthal (D-CT).<sup>87</sup> Those two bills would also broaden the compensation limit to cover all employees instead of just a few top executives and would raise revenue by approximately \$50 billion over 10 years.<sup>88</sup>

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## Business entertainment expenses

Companies are currently allowed to deduct half of their entertainment costs if the entertainment is for business purposes.<sup>89</sup> It is difficult for the IRS to ascertain whether a restaurant bill, golf fees, or other entertainment expenses are truly related or necessary to conducting the company's business, nor is it possible for the IRS to police claims of business entertainment expense. Moreover, there is a substantial element of personal enjoyment for the company's employees, apart from any business purpose.

In recognition of these facts, Rep. Camp's tax reform bill eliminates entertainment deductions, which the JCT estimates would raise about \$15 billion over 10 years.<sup>90</sup> Rep. Camp's House Ways and Means Committee Republican staff explain that "It is difficult for the IRS to determine whether entertainment expenses are directly related to a trade or business, creating uncertainty for taxpayers as well as the potential for significant abuse."<sup>91</sup> The Center for American Progress agreed with this assessment in an earlier report, titled "Priorities for Progressive, Pro-Growth Corporate Tax Reform."<sup>92</sup> These rationales are consistent with consensus principles of simplifying the tax code and minimizing distortions in otherwise normal economic decisions, since some businesses may be choosing to spend more on entertainment because of the deduction.

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## Percentage depletion

Regardless of one's views on energy independence, pollution, and global warming, the enormous profits earned by the large companies in the oil and gas industry indicate that this is not an industry in need of government subsidies.<sup>93</sup> President Obama's FY 2015 budget proposes eliminating oil and gas tax subsidies that would otherwise be worth about \$51 billion over 10 years.<sup>94</sup> One such subsidy is the so-called "percentage depletion" rule.

Businesses engaged in mining, drilling, stone quarrying, and timber harvesting deduct their capital costs using one of two depletion methods. All companies may use the cost method, which allows companies to take a deduction that is proportional to the share of resources extracted from their property.<sup>95</sup> Some companies also have the option to use the percentage depletion method, in which the company deducts a flat percentage from the gross income earned from the property.<sup>96</sup> The percentage depletion method often delivers larger tax benefits. Since percentage depletion allows a deduction that is unrelated to the actual share of extracted resources, percentage depletion deductions can exceed the company's actual capital costs over time.<sup>97</sup>

Congress already repealed the percentage depletion subsidy for the largest oil companies in 1975, but the subsidy is still available for smaller producers.<sup>98</sup> Rep. Camp proposes eliminating percentage depletion entirely and requiring all taxpayers to use the cost depletion rules.<sup>99</sup> President Obama's FY 2015 budget eliminates percentage depletion as it applies to fossil fuel producers, which JCT estimates would raise revenues by \$17 billion over 10 years.<sup>100</sup> Eliminating the subsidy is consistent with the consensus principle of broadening the tax base by reducing tax breaks that shelter income from normal taxation.

Percentage  
depletion  
deductions can  
exceed the  
company's actual  
capital costs  
over time.

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## Dual capacity rules

When a multinational company repatriates foreign-sourced income, the foreign tax credit allows the company to subtract from their U.S. tax bill any income tax they have paid to foreign governments on that same income, except to the extent the foreign tax exceeds the company's U.S. tax. This policy exists to avoid double taxation; the foreign tax credit prevents corporations from paying taxes twice on the same foreign income. At the same time, corporations cannot claim a foreign tax credit for payments made to foreign governments in return for specific benefits, since those payments are not an income tax; rather, they are more like an ordinary business expense such as wages or rent, which are deductible from taxable income.<sup>101</sup>

Since a deduction only reduces taxable income, rather than the tax bill itself, the corporation gets less of a tax break from the deduction than they would from the foreign tax credit. Companies that pay both income taxes and other expenses to foreign governments are known as “dual capacity taxpayers.”

An oil company, for example, may deduct royalties paid to a foreign government for drilling rights as a business expense, but it may not claim a foreign tax credit for those payments.<sup>102</sup> However, some foreign governments impose levies on oil and gas companies that are higher than the foreign country’s general income tax rate.<sup>103</sup> In reality, part of the levy represents an income tax equivalent and the rest represents a royalty for the right to extract the country’s natural resources. Yet, oil and gas companies can treat these payments as income taxes and thus claim a foreign tax credit for the entire amount.<sup>104</sup>

The bipartisan Wyden-Coats tax reform bill, along with President Obama’s FY 2015 budget, reforms rules for dual capacity taxpayers to prevent inappropriate use of the foreign tax credit for these ordinary business expenses.<sup>105</sup> The JCT estimates that this would raise \$12.2 billion over 10 years.<sup>106</sup> In essence, this promotes simplicity in that it keeps the lines clear between taxes paid on foreign income and ordinary business expenses necessary to earn that income.

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### Oil and Gas exception from passive loss limitations

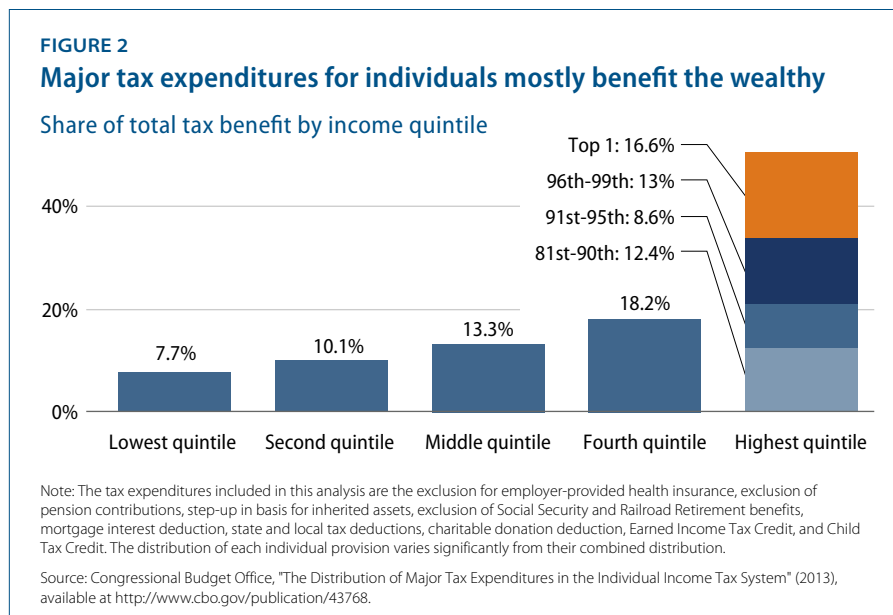
The Tax Reform Act of 1986 cracked down on the use of unprofitable investments as tax shelters by imposing passive loss limitations, which prevent investment losses from being used as tax deductions against other sources of income.<sup>107</sup> Instead, businesses may carry those passive losses forward and deduct them in future years from any profits their investment eventually earns.<sup>108</sup> However, Congress made an exception for oil and gas, which the Independent Petroleum Association of America defends on the grounds that it encourages investment in oil exploration since oil is not discovered in every drilled well.<sup>109</sup> However, this does not distinguish it from other business ventures.

President Obama’s FY 2015 budget and Rep. Camp’s tax reform bill both eliminate the oil and gas exception from passive loss limitations, which JCT estimates will raise revenue by \$224 million over 10 years.<sup>110</sup> The explanations from both the Obama administration and Rep. Camp’s House Ways and Means Committee justify this provision on the grounds that it treats all taxpayers more equally.<sup>111</sup>



# Individual tax improvements

The overwhelming majority of the more than \$1 trillion of expenditures in the tax code goes to individuals. While some of these provisions deliver significant tax relief to the poor and middle class, most of the benefits from the major individual tax expenditures flow to the wealthy.<sup>112</sup>



The United States is currently experiencing income inequality of historic proportions. The proliferation of tax expenditures that benefit upper-income taxpayers exacerbates this inequality and erodes the progressive structure of the income tax system. The progressive income tax is a critical element of our overall tax system, since it offsets the regressive structure of federal payroll and excise taxes, as well as many state and local taxes.

Particularly at the high end of the income distribution, allowing taxpayers to shelter income from tax that otherwise would apply reduces the revenues that fund

important public programs and forces the rest of us to make up the difference somehow. Thus, as a matter of fairness, it makes sense to broaden the individual tax base by eliminating tax breaks that shelter income from normal taxation or only benefit a small class of upper-income people. In addition, Congress should close loopholes that distort normal economic choices for the sole aim of avoiding tax.

Policymakers of all stripes, as well as taxpayers, also seek a simpler tax code. The sections of the tax code that apply to individuals are loaded with complex, unfair, and economically distorting expenditures, and both conservative and progressive leaders have begun to reach a consensus on how to improve the tax code for individuals.

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### Exclusions from income and itemized deductions

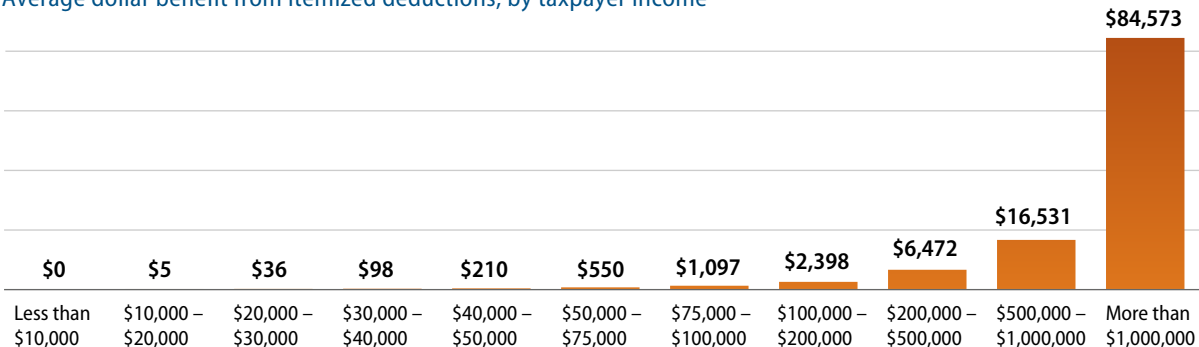
Itemized deductions are an assortment of deductions taken by taxpayers in lieu of the standard deduction.<sup>113</sup> One-third of all taxpayers itemize their deductions instead of taking the standard deduction.<sup>114</sup> The five largest itemized deductions—which are for mortgage interest, state and local income or sales taxes, charitable donations, real estate taxes, and high medical bills—cost the federal government more than \$200 billion per year.<sup>115</sup>

The wealthiest Americans are the most likely to itemize and also claim the largest itemized deductions. In 2011, 98 percent of taxpayers who earned more than \$1 million per year chose to itemize their deductions, and those who did claimed an average of \$441,719 in itemized deductions.<sup>116</sup> Meanwhile, 55 percent of taxpayers who made between \$50,000 and \$100,000 itemized their deductions, claiming an average itemized deduction of \$19,441.<sup>117</sup>

In addition to claiming higher itemized deductions, the wealthy also benefit the most from each dollar they deduct. Like all deductions, itemized deductions have what experts call an upside-down effect in our progressive tax rate structure.<sup>118</sup> Since high-earning individuals pay a higher marginal rate, a reduction in their taxable income reduces their total tax bill more than an identical deduction for someone facing a lower marginal rate. For instance, a \$1,000 deduction for a middle-class individual facing a 25 percent marginal tax rate would reduce their tax liability by \$250, while a \$1,000 deduction for a higher earner facing a 35 percent marginal tax rate would reduce their tax bill by \$350.

The combination of the upside-down effect and higher income earners claiming larger itemized deductions results in the tax benefits of itemized deductions flowing largely to those at the top of the income distribution. According to estimates by the Tax Policy Center, more than one-quarter of the tax savings from itemized deductions in 2015 will go to the 567,000 filers who make more than \$1 million per year, while less than one-fifth will go to the 130 million taxpayers who make less than \$100,000 per year.<sup>119</sup> While a middle-class taxpayer who makes \$75,000 to \$100,000 annually will get an average tax cut of \$1,097 from itemized deductions, taxpayers who earn more than \$1 million per year will reduce their tax bill by an average of \$84,573 using itemized deductions.<sup>120</sup>

**FIGURE 3**  
**Itemized deductions primarily benefit the wealthy**  
 Average dollar benefit from itemized deductions, by taxpayer income

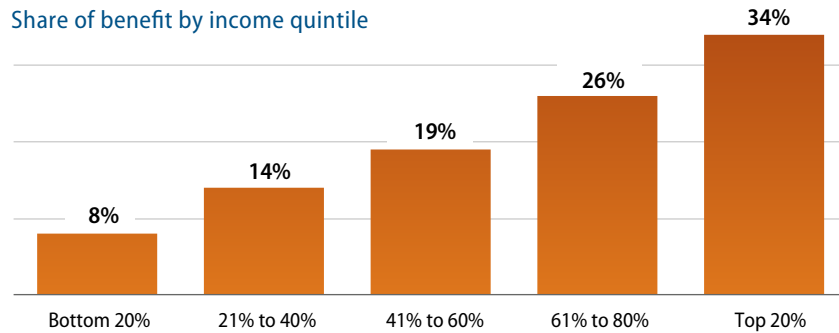


Source: Tax Policy Center, "Tax Benefit of All Itemized Deductions; Distribution of Federal Tax Change by Cash Income Level, 2015" (2013), available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3856&DocTypeID=1>.

In addition to itemized deductions, exclusions from income have the same upside-down, regressive characteristics, since those in higher tax brackets benefit more from a reduction in taxable income. The single largest expenditure in the entire tax code is the exclusion for employer-provided health insurance. Generally, workers pay taxes on the compensation they receive from work, but that compensation is exempt from both income and payroll taxes when it comes in the form of health insurance. The exclusion for employer-provided health insurance subsidizes coverage for the nearly half of all Americans who receive health insurance through their jobs.<sup>121</sup> The exclusion is expected to reduce income tax revenues by \$196 billion in FY 2014 alone with an additional \$123 billion reduction in payroll tax receipts.<sup>122</sup>

**FIGURE 4****The exclusion for employer-provided health insurance is regressive**

Share of benefit by income quintile



Source: Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System" (2013), available at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768\\_DistributionTaxExpenditures.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf).

Some deductions and exclusions support important policy objectives but nevertheless deliver the most benefit to high-income taxpayers who need government subsidies the least. To address this problem, President Obama has proposed limiting the value of most deductions and exclusions, including itemized deductions and the employer-provided health insurance exclusion, to 28 cents for every dollar deducted or excluded.<sup>123</sup> This limitation would mean that a billionaire would not receive a greater subsidy than a middle-class taxpayer when the two deduct or exclude the same amount from their income. For taxpayers at or below the 28 percent marginal tax rate, this proposal would not change anything. In 2014, the upper end of the 28 percent tax bracket is \$186,350 for single filers and \$226,850 for married taxpayers filing jointly.<sup>124</sup> Those with higher incomes would see the tax savings of their deductions and exclusions limited to 28 cents for every dollar. This proposal would raise nearly \$500 billion over 10 years.<sup>125</sup>

Similarly, Rep. Camp's tax reform bill would limit the value of most deductions and exclusions to 25 cents on the dollar. Rep. Camp's bill lowers the top tax rate to 35 percent, which includes a 10 percent surtax that cannot be reduced by most deductions or exclusions with the exception of charitable contributions.<sup>126</sup> Incomes greater than \$400,000 for single filers, or \$450,000 for joint filers, would be subject to the surtax. Since most deductions and exclusions would only apply to the 25 percent regular tax rate and not the 10 percent surtax, their value would be limited to 25 percent. So Rep. Camp's surtax acts in substantially the same way as President Obama's limitation.

Each of these proposals advances the principle of broadening the tax base by reducing the amount of income that can be sheltered from normal taxation.

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## Housing tax expenditures

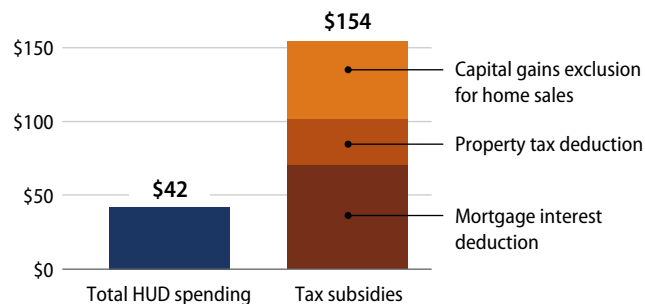
Federal housing subsidies flow primarily through the tax code. The Office of Management and Budget, or OMB, expects the mortgage interest deduction to cost the government \$70 billion in FY 2014 alone.<sup>127</sup> The federal tax deduction for state property taxes paid will cost about \$32 billion in FY 2014.<sup>128</sup> Homeowners also do not have to pay taxes on up to \$250,000 of capital gains when they sell their primary residence, which doubles to \$500,000 for married taxpayers. That capital gains exclusion will cost the government about \$52 billion in FY 2014.<sup>129</sup> Together, these three housing tax expenditures—which primarily benefit higher-income taxpayers<sup>130</sup>—total \$154 billion for FY 2014. For a comparison, the entire U.S. Department of Housing and Urban Development, which administers the government’s largest affordable housing programs, will spend about \$42 billion in FY 2014.<sup>131</sup>

Unfortunately, those costly housing tax subsidies do not seem to be an efficient way to promote homeownership. A recent report from the conservative R Street Institute found that tax expenditures for housing have created a preference for larger houses without incentivizing home buying overall.<sup>132</sup> Furthermore, the benefits of the mortgage interest deduction flow overwhelmingly to those who could afford to buy a home without government assistance, with more than 50 percent of the tax value of the mortgage interest deduction going to the top 10 percent of income earners.<sup>133</sup>

Limiting the value of itemized deductions would reduce the mortgage interest deduction’s disproportionate benefit for high-bracket income earners, but additional reforms could still be made. Currently, the interest on mortgages up to \$1 million is deductible, but Rep. Camp would phase that limit down to \$500,000 over several years.<sup>134</sup> This would raise revenues by about \$41 billion over 10 years.<sup>135</sup> Rep. Camp argues that his ceiling on the mortgage interest deduction supports homeownership, without encouraging homeowners to buy larger homes or take on excessive mortgage debt. Sen. Mike Lee’s (R-UT) Family Fairness and Opportunity Tax Reform Act would lower the limit for the mortgage interest deduction even further to only cover interest payments on up to \$300,000 of a home mortgage.<sup>136</sup>

**FIGURE 5**  
Federal housing subsidies flow primarily through the tax code

Budgetary impact of selected policies in 2014, in billions of dollars



Source: Office of Management and Budget, *Fiscal Year 2015 Budget of the U.S. Government* (The White House, 2014), available at <http://www.whitehouse.gov/omb/>.

Furthermore, Rep. Camp tightens the rules for excluding capital gains from the sale of a house in his reform in order to focus the benefit on long-time homeowners. Rep. Camp would limit the exclusion to homeowners who lived in their home for five out of the past eight years, while current law only requires homeowners to live in their home for two out of the past five years to claim the exclusion. His plan would also phase out the exclusion for taxpayers with income exceeding \$500,000.<sup>137</sup> This provision would raise about \$16 billion over 10 years.<sup>138</sup>

The progressive coalition Americans for Tax Fairness, of which the Center for American Progress is a member, and the National Women’s Law Center highlighted Rep. Camp’s proposals to limit the mortgage interest deduction and the capital gains exclusion for home sales in a report titled “A Good Starting Point: 23 Options from Rep. Dave Camp for Closing Tax Loopholes.”<sup>139</sup>

Separately, a recent report by Benjamin H. Harris of the Brookings Institution and C. Eugene Steuerle and Amanda Eng of the Urban Institute advocates capping the mortgage interest deduction at 15 percent and repealing the property tax deduction, while introducing one of three proposed tax credits to encourage homeownership.<sup>140</sup> The paper offers a choice between a first-time homebuyer tax credit of up to \$12,000, or \$18,000 for married taxpayers; a property tax credit worth up to \$1,400 per year, or \$2,100 for married taxpayers; or an annual homeowner tax credit of \$870 per year, or \$1,300 for married taxpayers, that would phase out for wealthier homeowners.<sup>141</sup> Each of these ideas has benefits and drawbacks, but they all seek to distribute tax relief more evenly among homeowners and create a more efficient incentive to encourage homeownership.

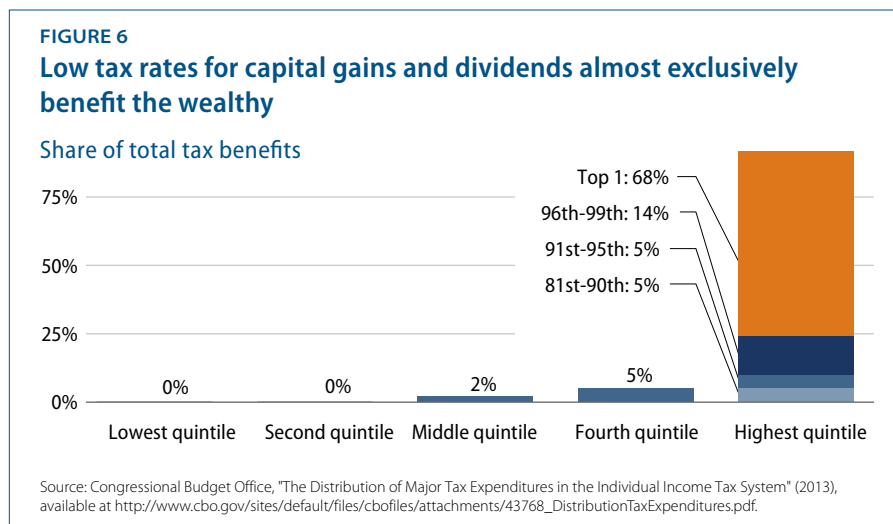
The tax code plays an important role in housing subsidies, but progressives and conservatives agree that the current system goes beyond promoting homeownership to deliver unnecessary subsidies to wealthy homeowners. Thus, as discussed above, both sides have ideas to reform tax expenditures for housing, and all of their ideas aim to reduce the tax breaks at the higher end of the income spectrum.

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## Capital gains and dividends

Our tax system gives preferential treatment to income from capital gains and dividends, with these sources taxed at lower rates than income from work, such as salaries. Labor income is taxed at a top marginal rate of 39.6 percent and also subject to payroll taxes, while capital gains and dividends are taxed at a top rate of 23.8 percent and exempt from payroll taxes.<sup>142</sup>

Under current law, capital gains on assets held for more than one year and dividends from corporate stock are taxed at reduced rates with a base rate of 20 percent for high-income households. Additionally, the Affordable Care Act, or ACA, added a 3.8 percent surtax on investment income for high-earners, bringing the top tax rate to 23.8 percent for capital gains and dividends. The CBO estimated in 2013 that 68 percent of the benefit from reduced taxes on investment income flowed to the top 1 percent, and 93 percent of the benefit flowed to the top 20 percent. The bottom 40 percent receives less than 1 percent of the proceeds from reduced capital gains and dividend tax rates.<sup>143</sup>



The benefits of reduced tax rates on investment income are heavily skewed toward those at the top because that group owns most of the wealth with which one could invest. The top 10 percent hold more than 70 percent of all the wealth in the United States.<sup>144</sup> The top 0.1 percent of Americans now hold more than 20 percent of American wealth—an imbalance not seen since the 1920s—with the top 0.01 percent holding more than 10 percent of the total.<sup>145</sup> Even though low-income taxpayers pay a 0 percent tax rate on investment income, the benefit is minimal since this group owns barely any wealth to invest.<sup>146</sup>

Rep. Camp's bill would raise taxes on investment income, as would several earlier bipartisan proposals. This is a big difference from some earlier conservative proposals to completely eliminate taxes on capital gains, dividends, and interest, such as Rep. Paul Ryan's (R-WI) Roadmap for America's Future Act of 2010.<sup>147</sup> In addition to

almost exclusively benefitting the wealthy, proposals for tax-free investment income are based on fundamentally flawed economic models that assume anyone can borrow an unlimited amount of money with which to invest and everyone makes rational long-term savings decisions, despite substantial evidence to the contrary.<sup>148</sup> More realistic assumptions produce models of optimal tax policies that include taxing investment income.<sup>149</sup> Even Rep. Ryan has dropped his call for tax-free investment income in his more recent budgets.<sup>150</sup>

Rep. Camp proposes exempting 40 percent of capital gains and dividends from taxation and taxing the rest as ordinary income.<sup>151</sup> Taxing 60 percent of investment income at Rep. Camp's top rate of 35 percent is the equivalent of a 21 percent tax rate, or a 24.8 percent rate with the ACA surtax included. Since Rep. Camp does not repeal the ACA surtax on investment income, his proposal effectively raises statutory capital gains and dividend tax rates by 1 percentage point for high earners relative to current law. However, an analysis by the Tax Policy Center finds that the effective marginal tax rate—meaning the actual rate paid on an extra dollar of income—may actually fall slightly for capital gains and dividends for the wealthy under Rep. Camp's proposal, due to the interaction of his new exemption system with other parts of the tax code.<sup>152</sup> The Joint Committee on Taxation estimates that Rep. Camp's capital gains and dividend provisions would raise revenue by about \$45 billion over 10 years.<sup>153</sup>

The Wyden-Coats tax reform bill used the same basic approach for taxing investment income as Rep. Camp but only exempted 35 percent from taxation instead of 40 percent.<sup>154</sup> Since their bill also reduced the top income tax rate to 35 percent, this would result in a 22.75 percent statutory tax rate on investment income, or 26.55 percent with the ACA surtax.

Two bipartisan commissions—one chaired by President Bill Clinton's former Chief of Staff Erskine Bowles and former Sen. Alan Simpson (R-WY) and the other chaired by former Sen. Pete Domenici (R-NM) and President Clinton's former Budget Director Alice Rivlin—went even further. Both commissions recommended eliminating preferences for investment income and taxing capital gains and dividends at ordinary rates, although the Domenici-Rivlin commission allowed an exemption for the first \$1,000 of capital gains.<sup>155</sup> Both commissions also sharply lowered top tax rates, with Bowles-Simpson using a 28 percent rate in its illustrative example of tax reform and Domenici-Rivlin endorsing a 27 percent rate. Even with these lower rates, however, investment income would still face higher taxation than under current law. The Bowles-Simpson commission also



allowed for the possibility of excluding a portion of investment income from taxation, as Rep. Camp and Wyden-Coats do, but made clear that the tradeoff for this would be a higher top tax rate.<sup>156</sup>

Excluding a portion of investment income and taxing the rest at ordinary rates is the preferred approach of many proposals, with all such policies keeping the exclusion low enough to raise investment taxes relative to current law. But Congress could also choose to follow the approach of the Bowles-Simpson commission and fully equalize tax treatment for income from work and income from investments. Alternatively, the limited exception proposed by the Domenici-Rivlin commission would focus investment tax benefits more on the upper-middle class, since a \$1,000 exemption would be nearly invisible on a billionaire's tax bill but still important for less wealthy households. Regardless of which approach is chosen, it is clear that there is bipartisan support for broadening the tax base by narrowing the gap between the tax on capital and the tax on ordinary income.

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## Carried interest

Individuals who perform management services for an investment services partnership, such as a hedge fund or a private equity fund, often structure their compensation to take advantage of tax preferences for investment income by taking an interest in the fund, rather than receiving a normal salary for their services. The so-called “carried interest” or “profits interest” pays the manager a fixed percentage of the profit earned by the investment fund, but that percentage does not reflect money personally invested by the manager.<sup>157</sup> In other words, carried interest compensation is not a return on the fund manager's investment; it is performance-based compensation for their work. Thus, while everyone else's labor compensation is taxed as ordinary income, extremely wealthy fund managers' labor compensation is taxed as investment income at far lower rates, as described in the capital gains discussion above. Investment fund managers can combine the carried interest loophole with other tax benefits, such as by placing their carried interest into an IRA, in order to significantly enhance their tax savings.

President Obama proposes taxing all of a fund manager's carried interest compensation as labor income, subject to both ordinary income tax and payroll tax, unless this income was actually from capital invested personally by the fund manager.<sup>158</sup>

Some reports indicate that congressional Republicans are open to closing this loophole as well.<sup>159</sup> Rep. Camp calls carried interest a “lobbyist loophole” but proposes a more narrow approach to closing it than President Obama does.<sup>160</sup> Rep. Camp’s legislation would treat some, but not all, carried interest payments as ordinary income. Under this approach, carried interest payments that reflect a return on investment of up to 10 percentage points higher than the federal long-term interest rate would be taxed as ordinary income.<sup>161</sup> Any carried interest payment exceeding that level would be taxed at the lower capital gains rate.

The JCT estimates that President Obama’s carried interest proposal would raise \$17 billion over 10 years.<sup>162</sup> Rep. Camp’s rules would raise \$3 billion as part of his comprehensive tax reform.<sup>163</sup> Both President Obama and Rep. Camp seem to recognize that the carried interest loophole is a tax preference that narrows the tax base and benefits a small group of wealthy individuals.

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## Like-kind exchanges

Under current law, owners of property used for business or investment can defer recognition of capital gain when they exchange it for a similar type of property, rather than selling it outright.<sup>164</sup> These rules are frequently used to avoid capital gains taxes on real estate investments, but other types of business and investment property can also qualify, including art and classic cars.<sup>165</sup> According to Rep. Camp’s Republican staff on the House Ways and Means Committee, “The current rules have no precise definition of ‘like-kind,’ which often leads to controversy with the IRS and provides significant opportunities for abuse.”<sup>166</sup> Rep. Camp’s staff caution that the rules enable investors to defer capital gains taxes for decades or avoid them entirely if the owner of the property dies before realizing their gain for tax purposes.<sup>167</sup>

Rep. Camp proposes eliminating like-kind exchange rules entirely in his tax reform bill, which would raise about \$41 billion over 10 years.<sup>168</sup> President Obama proposes a more modest approach. For real property only, his proposal would limit taxpayers to \$1 million per year in deferred capital gains taxes for property used in a like-kind exchange.<sup>169</sup> This approach would raise about \$11 billion over 10 years.<sup>170</sup> The U.S. Treasury Department points out that the rule’s historical justification with respect to real property—the difficulty of valuing exchanged property—is no longer true.<sup>171</sup> In any case, both proposals are consistent with the shared tax principles of broadening the tax base by eliminating tax breaks that shelter income from normal taxation without adequate clarity or justification.

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## Gingrich-Edwards loophole

Both President Obama and Rep. Camp call for closing the “Gingrich-Edwards” loophole.<sup>172</sup> This loophole allows some wealthy professionals to form their own corporations to avoid self-employment taxes, which are equivalent to payroll taxes for self-employed workers and are imposed under the Self-Employment Contributions Act, or SECA.<sup>173</sup> Customers pay the corporations for the professionals’ services, such as consulting or entertainment. These professionals then pay themselves a wage from their corporation and receive the rest of the profits as a dividend.

While both wages and dividends are subject to income taxes, only wages are subject to payroll taxes. So professionals who form their own corporation have an incentive to pay themselves an artificially low wage and shift the remainder of their income into a larger dividend. IRS rules are supposed to prevent this, but the Government Accountability Office, or GAO, has found that those rules often fail to stop abuse.<sup>174</sup> For example, this tax strategy helped former Speaker of the House Newt Gingrich (R-GA) and former U.S. Sen. John Edwards (D-NC) avoid payroll taxes on the earnings they received for public speaking and providing legal services, respectively, giving the loophole its name.<sup>175</sup> While middle-class Americans pay their fair share of payroll or self-employment taxes for Medicare and Social Security, some wealthy professionals are escaping their obligation simply through structuring their earnings as a dividend rather than a wage.

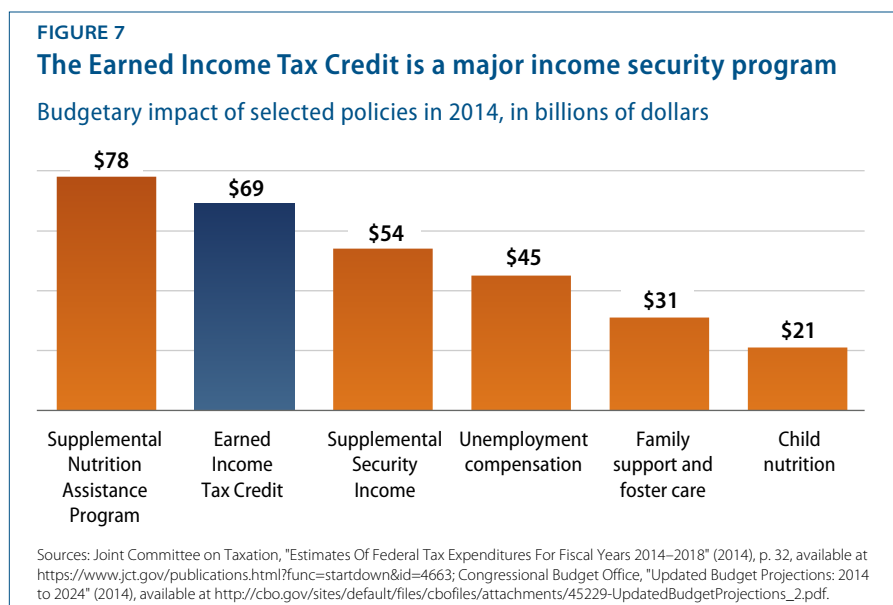
The ability to avoid payroll taxes on earnings is a problem in a number of “pass-through” entities—businesses that do not pay tax at the corporate level but pass on all income and expenses pro rata to the owners of the entity. According to the Treasury Department, because of the outdated structure of the tax code around the application of payroll taxes to pass-through entities, “some business owners pay employment taxes on nearly all their earnings (general partners and sole proprietors), other similarly situated owners pay employment taxes on only a portion of their earnings (S corporation owner-employees), and others pay little employment tax at all (limited partners and many LLC members).”<sup>176</sup>

President Obama proposes closing this loophole by imposing self-employment taxes on all income, whether through wages or dividends, that professionals receive for providing services through their businesses, regardless of corporate structure, as long as they materially participate in the business.<sup>177</sup> If they do not materially participate, they only pay SECA taxes on reasonable compensation associated with their services to the business.<sup>178</sup> The JCT estimates that this would raise \$25

billion over 10 years.<sup>179</sup> Rep. Camp's tax reform bill would also subject this income to self-employment taxes if the owner materially participates but permits a 30 percent deduction from self-employment tax base, which is intended to approximate the share of the owner's income from a return on their capital investment.<sup>180</sup> Owners who do not materially participate would pay no SECA taxes at all.<sup>181</sup> JCT estimates that this change would raise \$15 billion over 10 years as part of Chairman Camp's comprehensive tax reform.<sup>182</sup> Both of these proposals represent base broadening measures that promote fairness among taxpayers.

# Expanding the Earned Income Tax Credit

The Earned Income Tax Credit was created in 1975 and has since grown into one of the federal government's largest anti-poverty programs.<sup>183</sup> Low-income workers receive the EITC as part of their tax refund. They must work to claim the EITC. Very-low-income workers receive a larger EITC as they earn more, until they reach the maximum amount, and then the EITC phases out as workers continue to earn more and approach middle-class status. Presidents Ronald Reagan and Bill Clinton both signed expansions of the EITC into law during their respective administrations.<sup>184</sup>



The American Recovery and Reinvestment Act of 2009, commonly known as the stimulus package, temporarily increased the EITC for married taxpayers and large families with three or more children.<sup>185</sup> Congress extended those expansions twice on a bipartisan basis: first through 2012 in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010<sup>186</sup> and then through 2017 as part

of the American Taxpayer Relief Act, which Congress passed to address the “fiscal cliff” at the end of 2012.<sup>187</sup> Extending this bipartisan expansion permanently would increase deficits by about \$23 billion over the next 10 years.<sup>188</sup>

While the EITC delivers substantial benefits to families with children, it does little for childless workers.

While the EITC delivers substantial benefits to families with children, it does little for childless workers. In 2013, a taxpayer with one child could claim a maximum benefit of \$3,250, which increased to \$6,044 for a taxpayer with three or more children.<sup>189</sup> The maximum benefit for a childless taxpayer was \$487.<sup>190</sup>

Additionally, the EITC completely phased out for unmarried childless workers making more than \$14,340 in 2013, while an unmarried worker with a child making up to \$37,870 could claim the EITC.<sup>191</sup>

Many conservatives strongly advocate expanding the EITC for childless workers.<sup>192</sup> In his 2014 State of the Union address, President Obama said, “I agree with Republicans like Senator Rubio that [the EITC] doesn’t do enough for single workers who don’t have kids.”<sup>193</sup> President Obama advocates doubling the maximum credit for childless workers and raising the income threshold at which their EITC phases out completely to \$18,070, or \$23,750 if the taxpayer is married and filing jointly.<sup>194</sup> Additionally, President Obama would allow young childless workers to claim the credit starting at age 21 and allow older childless workers to claim it until age 67.<sup>195</sup> Currently, the EITC is not available for childless workers younger than age 25 or age 65 or older.<sup>196</sup> President Obama’s proposal would cost about \$61 billion over 10 years.<sup>197</sup> Rep. Ryan endorsed an almost identical EITC expansion in his anti-poverty plan, with the only difference being that Rep. Ryan would not expand eligibility for older workers.<sup>198</sup>

The EITC kept 6.5 million people out of poverty in 2012.<sup>199</sup> Expanding the EITC for childless workers would lift even more struggling workers out of poverty using an effective and bipartisan approach. Moreover, the EITC is consistent with good tax policy as all sides agree there is solid justification for sheltering income of low-income workers and providing a boost to encourage them to work even harder to achieve a higher level of financial security. The tax code is an efficient way for government to provide this social insurance.

Enacting some of the revenue-raising policies presented in this paper could offset the cost of expanding the EITC. Even elected officials beholden to Grover Norquist’s pledge could support this package since it would be revenue neutral.

# Conclusion

When the political system seems incapable of compromise, it is easy to understand why policy changes are not made on issues where progressives and conservatives disagree. But even with political gridlock and anti-tax ideology, Congress and President Obama should still be able to improve the tax code in cases where there is agreement on both sides of the aisle.

Sen. Murray (D-WA), for example, recently introduced legislation that pairs two tax increases endorsed by Rep. Camp (R-MI) with two tax cuts, including an expansion of the EITC for childless workers.<sup>200</sup> A recent paper from the conservative American Enterprise Institute supports both of the tax cuts in Sen. Murray's legislation.<sup>201</sup> There should be no reason for anyone to oppose this framework—it is revenue neutral and uses policies that both sides support.

Ultimately, it is fortunate that both sides can agree on reasonable approaches to raise revenue, since new revenue will be critical to sustaining a healthy federal budget that supports the needs of an aging population and creates economic opportunity for all Americans. Every bipartisan plan to address long-term federal debt involves pairing new revenue sources with spending cuts.<sup>202</sup> But there is no reason to wait for Congress to strike the elusive grand bargain to make smart changes to the tax code. Just as Congress has repeatedly cut spending without corresponding revenue increases, Congress should also act on bipartisan ideas to raise revenue, especially where both sides agree that doing so is consistent with principles of good tax policy.

Even a gridlocked Congress should be able to enact at least some of the proposals that progressives and conservatives agree are in the nation's best interests.





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# Appendix A: Revenue estimates

## Estimated revenue impact from bipartisan tax proposals

10-year deficit reduction in billions of dollars

	10-year revenue impact in billions of dollars
<b>Business tax improvements</b>	
Depreciation and expensing	
Repeal MACRS (Camp proposal)	\$269.5
<i>Note: Repeal of accelerated depreciation for corporate jets alone raises \$3.8 billion</i>	
Require amortization for half of advertising costs	\$169.0
Corporate jet subsidy	(Included in MACRS repeal)
LIFO accounting	\$106.0
Earnings stripping (Camp proposal)	\$24.0
<i>Note: Obama proposal raises \$51.4 billion</i>	
Transfer pricing (Excess returns proposal)	\$21.3
<i>Note: Separate score for proposal in Camp bill is not available</i>	
Corporate-owned life insurance	\$7.4
Bank tax (Camp proposal)	\$86.4
<i>Note: Obama proposal raises \$47.9 billion</i>	
Mark-to-market accounting for derivatives	\$14.3
Executive compensation (Camp proposal)	\$12.1
<i>Note: Reed-Blumenthal proposal raises \$50 billion</i>	
Business entertainment expenses	\$14.7
Percentage depletion	\$17.5
Dual capacity rules	\$12.2
Oil and gas exception from passive loss limitations	\$0.2
<b>Subtotal: Business tax improvements</b>	<b>\$754.6</b>

<b>Individual tax improvements</b>	
Exclusions from income and itemized deductions (Obama proposal)	\$497.6
<i>Note: Separate score for Camp proposal is not available</i>	
Housing tax expenditures	
Reduce limit on deductible mortgage interest to \$500,000	\$41.1
Limit capital gains exclusion on home sales	\$15.8
Capital gains and dividends (Camp proposal)	\$44.7
Carried Interest (Camp proposal)	\$3.1
<i>Note: Obama proposal raises \$17.2 billion</i>	
Like-kind exchanges (Camp proposal)	\$40.9
<i>Note: Obama proposal raises \$10.8 billion</i>	
Gingrich-Edwards loophole (Camp proposal)	\$15.3
<i>Note: Obama proposal raises \$25 billion</i>	
<b>Subtotal: Individual tax improvements</b>	<b>\$658.5</b>
<b>Expanding the Earned Income Tax Credit</b>	
Extend ARRA expansions	-\$23.2
Raise EITC for childless workers (Obama proposal)	-\$60.6
<b>Subtotal: Expanding the Earned Income Tax Credit</b>	<b>-\$83.8</b>
<b>Grand total</b>	<b>\$1,329.3</b>
Note: Total tax increases	\$1,413.1
Note: Total tax cuts	\$83.8

Note: The exact parameters of the scores for each proposal may differ, and these figures should be understood as an approximation. This table includes the most recent 10-year score available for each proposal, but these do not always cover the same time period. Additionally, some scores include interaction effects with other provisions in a larger bill, such as lower marginal tax rates.  
Source: Joint Committee on Taxation.

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