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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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EXTENDERS BILL (H.R. 4213) UP FOR ACTION IN SENATE

The House of Representatives has passed an "extenders" bill, H.R. 4213, formally named the American Jobs and Closing Tax Loopholes Act of 2010. On June 8, the Senate leadership introduced its own proposal, which makes modest changes to the House version of H.R. 4213. The bill would extend a large number of expiring tax and spending provisions.

The bill can be summarized briefly.

- It renews a large number of expiring business tax provisions for 2010, including the R&D credit, protection of financial service firms' income earned abroad from Subpart F "passive income" penalties, and extends or provides new tax breaks for many types of energy-related projects.
- It renews individual tax provisions for charitable contributions from retirement plans, energy saving activities, and certain above the line itemized deductions for state and local taxes and tuition, and dozens of other minor subsidies and credits, many in the energy saving area.
- It reduces various federal limits on state and local issuance of tax-exempt bonds and encourages additional state and local borrowing for infrastructure and other spending.
- It extends the full federal funding of additional weeks of unemployment compensation of up to 99 weeks of benefits enacted earlier in the recession.
- It includes a "doc fix" to postpone cuts in the reimbursement rates paid to physicians for Medicare services, and it extends a temporary additional level of federal matching support for state Medicaid programs.

The extenders bill is a bad piece of legislation for many reasons.

The bill would renew several important existing tax provisions that mitigate the tax burden on capital formation and business activity. Two of the most important are the R&D credit and the protection of financial service firms' income earned abroad from subpart F "passive income" penalties. These provisions should be extended. However, the extenders bill also contains many wasteful provisions that should be dropped.

The desirable provisions should be made permanent. To the bill's discredit, the "good" provisions would only be extended for another year. Temporary extensions help Congress play its usual games with the budget totals.

Regrettably, the revenue offsets chosen to pay for the extensions are permanent tax increases. Every year, the extenders charade forces taxpayers to accept permanent tax increases in exchange for temporary deferral of other pending tax increases. It is a bad bargain for taxpayers and the economy.

The estimated revenue cost of the key tax relief extensions is overstated. Without the tax provisions, the activities receiving the tax relief would be restructured or not undertaken. Elimination of the provisions would yield far less revenue than indicated by the supposed "cost" of keeping the incentives in place. Therefore, the need for revenue offsets is overstated.

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The revenue offsets (tax increases), notably revenue raising provisions on carried interest and restrictions on access to the foreign tax credit, are bad tax policy, and will not yield the anticipated revenue. They are likely to trigger a restructuring of the affected industries and depress investment, growth, and employment. Consequently, they will not yield the revenue estimated by the Joint Committee on Taxation.

The bill's non-medical spending provisions are generally ill-advised and should be scaled back.

Nothing in the bill would increase growth or employment beyond what would be expected under current tax levels, and the revenue raisers would depress activity. On balance, the bill is likely to reduce economic activity and employment.

The extenders, section by section

The Congressional Budget Office reports that the Senate bill would raise $47.489 billion in revenue over ten years. The revenue increases exceed the cost of extending expiring tax provisions. The revenue increase would fund a portion of the extension of expiring spending provisions. Nonetheless, spending would rise by $126.140 billion over ten years. The largest increases would be for infrastructure incentives ($25.623 billion), unemployment and other assistance ($41.350 billion) and health spending ($44.145 billion). The net addition to the deficit would be $78.651 billion (an increase of $84.915 billion on-budget, a decrease of $6.264 off-budget).

The infrastructure incentives plus the energy provisions within the business and individual tax extenders section represent a considerable portion of the cost of the bill. They are largely wasteful and should be eliminated.

Infrastructure incentives, Title I

Infrastructure incentives are a major portion of the bill. They primarily take the form of tax credits for interest on taxable forms of state and local bonds, easing of volume limitations on the issue of state and local tax-exempt bonds, for certain types of construction-related investment, such as sewage treatment and water supply projects, and temporary easing of the rules that subject private purpose bond interest to the AMT (alternative minimum tax).

The largest single provision is the extension of the stimulus package's Build America Bond program, costing $4.042 billion. The Build America Bond program gives a federal subsidy in the form of a credit on interest paid on a taxable form of state and local debt, making the bonds attractive to lower bracket taxpayers, and to tax-exempt groups, or for holding in tax-deferred pension arrangements that would not normally be a market for tax-exempt state and local debt. The taxpayer credit, 32% of the interest in 2011 and 30% in 20012, is more generous than a simple tax exemption to people in tax brackets 28% and below. It is an added incentive for local governments to borrow and spend. The infrastructure incentive programs were designed to give a boost to local government construction projects during the recession. Most did not get under way in time to blunt the recession. Continuation of them during the recovery is not warranted.

Extension of expiring provisions, Title II

This part of the bill has four sections: Energy, Individual Tax Relief, Business Tax Relief, and Temporary Disaster Relief.

<u>Energy provisions for businesses and individuals</u> offer credits and other incentives to encourage development and use of otherwise uneconomical alternative fuels, alternative motor vehicles, and the construction and refitting of energy efficient buildings and the purchase of energy efficient appliances. The credits and incentives in this section are very inefficient ways of avoiding the use of imported energy or of curbing emissions of carbon dioxide, and are not warranted at any time, but especially not during the current budget difficulties.

Individual Tax Relief provisions (other than energy) are generally reasonable. About a third are deductions for charity (e.g. according gifts from IRAs similar treatment as gifts from other sources) or deduction for tuition (an investment in human capital) that make good economic and tax consistency sense. About $1.551 billion is for an additional standard deduction for state and local real personal property taxes, and $1.8 billion extends the deduction for state and local general sales taxes for individuals who itemize in states with no or low income taxes. It is generally poor tax policy to tax a tax, although the standard deduction was once supposed to cover such items for most taxpayers.

Business Tax Relief provisions are the biggest category.

• *The R&D credit.* The largest item is the $6.65 billion extension of the research and experimentation tax credit. This credit reduces the risk of R&D efforts that are particularly risky for the business undertaking them, and that often have positive spill-over effects on other businesses not captured by the original researchers. The credit is designed to raise the rewards to the businesses doing the R&D to more fully reflect the social value of their efforts. The credit improves productivity and raises wages in the economy. Its true cost after the "dynamic" improvement in the economy is less than the direct "static" cost estimated by the JCT.

• *Extension of the subpart F exception for financial firms.* Another key provision, with a static cost estimate of $3.923 billion, is the extension of the exception under subpart F for active financing income of multinational financial businesses. Non-financial multinational U.S. businesses can defer tax on the income from their "active" foreign business (manufacturing, trade, services, etc.) until it is repatriated, but must report immediately their financial ("passive") income from cash balances and financial instruments held by their foreign operations (which in theory could as easily be held in the United States). However, interest and dividend income generated by financial services businesses (banks, brokerage firms, and insurance companies) is the product of their actual "active" business, not an incidental side-effect of other "active" operations. Unless these firms are allowed an exception to the "passive" tax rules on the financial earnings from their foreign offices, they would be unable to compete with financial firms of other countries in offering banking and other financial services to locals. Their foreign operations would have to be significantly curtailed or restructured, and there would be little income left for the U.S Treasury to tax. In reality, then, the "dynamic" cost of the subpart F exception does not cost anything like the static cost assumed by the JCT.

• *Expensing or faster write-off periods.* Many of the remaining provisions allow faster write-off of capital expenditures for certain categories of investment. Immediate expensing is the ideal treatment of investment outlays (and would be the norm in an unbiased, saving-consumption neutral, cash flow tax system), so shorter write-off periods are a step in the right direction. However, the relief would be less distorting and more efficient if it were extended across the board to all types of investment. Selecting special activities, such as sports stadiums, or limited geographic areas, such as depressed areas and the District of Columbia, for special treatment, while transportation, farming, mining, and manufacturing equipment and structures in general get no improvement, is not efficient.

Temporary Disaster Relief provisions consist mainly of immediate deduction of casualty losses or rapid depreciation of disaster-impacted property.

Pension provisions, Title III

Pension provisions raise a small amount of revenue over ten years. They allow underfunded pension plans to delay catching up to the full funding levels demanded by current law. As firms set less money aside for pension contributions in the next few years, they will have smaller deductions and higher taxable income. As they make up for the delay by contributing more to their pension plans in later years, their deductions will rise and their taxes will fall. The provisions raise revenue in the next ten years, but give it back later.

Revenue offsets, Title IV

<u>Carried interest to be taxed at higher tax rates.</u> This provision would curtail the capital gains treatment of some of the income of managing partners, called "carried interest," from the funds they manage, and tax it as ordinary income. The current treatment is not a clear violation of good tax policy, nor merely a sop the rich. The provision would raise the cost of investment and reduce productivity and wages across the board.

Investment fund partnerships are made up of general partners who manage the business, and limited partners who contribute the capital to invest. (General partners may also contribute some of the capital.) General partners may be paid a flat fee for their management services, in which case they are taxed at ordinary income at rates of up to 35% (due to rise to 39.6% when the Bush tax cuts expire next year). Often, the general partners receive payment for their services by being granted a portion of the partnership that was funded by the limited partners; the income from that transferred share is called carried interest. The general partners receive the carried interest portion of the partnership income in whatever form it takes. If it is a distribution of interest, it is taxed as ordinary income at rates up to 35% (39.6% next year); if dividends, up to 15% (due to rise to 39.6% when the Bush tax cuts expire); if capital gains, at the capital gains tax rate, currently 15% (due to rise to 20% when the Bush tax cuts expire).

The bill would require the general partners to treat a portion of the carried interest as ordinary income (and not receive the favorable capital gains tax rate) to the extent that their share of the partnership was not obtained by investment of their own money. In the earlier House version of the bill, the capital gains distributions would be treated as 50% ordinary income in 2011 and 2012; in 2013, it would be taxed as 75% ordinary income. The Senate amendment as submitted on June 8 would lower the percentages treated as ordinary income to 45% in 2011 and to 65% in 2014. The less severe Senate treatment would lower the expected revenue increase from $18.7 billion to $14.2 billion.

Proponents of the provision assert that the carried interest recipients are receiving payments for management services that are payments to labor, not investment income, and should not be granted the reduced tax rates available on capital gains (and dividends in 2010). Opponents protest that the higher tax rate on the capital gains generated by these investment businesses would raise the cost of operating these partnerships, and raise the cost of capital for plant and equipment investment in the United States. Productivity and wages would suffer.

Concern over capital gains tax treatment of general partners of investment funds is overdone. It is normal for income from all types of partnerships (investment funds or ordinary businesses organized as partnerships) to be passed through to the partners for tax purposes. (Unlike corporations, there is no additional tax at the business level.) The income that is passed through has always been taxed as the type of income that the partnership earned – as interest, capital gains, or dividends.

For the most part, it makes no difference to federal tax revenues whether payments to the general partner take the form of a fee or a piece of the partnership returns. This is true even if the returns get a reduced capital gain tax rate. The arrangement matters only in the special case in which some of the limited partners are tax-exempt institutions.

Consider a case in which the partnership earns capital gains, and the limited partner gets part of the total. The Treasury will collect an amount equal to the total capital gains income times the capital gains tax rate. It will collect some from the limited partners, and some from the general partners; the split would not affect the total revenue.

Then consider an alternative in which the partnership pays the general partners a management fee instead of carried interest, and the limited partners keep and pay tax on all the capital gains. The general partners would pay tax at ordinary tax rates on their fee, a higher tax payment than if they paid at the capital gains tax rate. But the limited partners would get a tax deduction for the fee that they could claim against ordinary income (because costs are also passed through to the partners). The tax they save with the deduction of the fee would equal the tax paid on the fee by the general partners, resulting in zero net revenue to the Treasury. The Treasury would be left only with the tax on the capital gains earned by the partnership, as in the first instance.

If carried interest were treated as ordinary income, it would be replaced by a fee structure that would net the Treasury no additional income. That would be unfortunate, because linking the returns of the management to the performance of the investments via carried interest is a strong motivator for them to make the investments as productive as possible.

An exception to the revenue neutrality across types of payments occurs if some of the limited partners are tax-exempt institutions such as schools, charities, and state and local government rainy day funds and pension plans. They would not be able to use their portion of the management fee as a tax deduction. The Treasury would notice an increase in tax revenues equal to the difference between the ordinary income tax rate and the capital gains tax rate on a portion of the fee equal to the portion of the partnership held by tax-exempt entities. The difference in revenue is traceable to the granting of tax-exempt status to the schools, charities, and state and local governments. In effect, treating carried interest as ordinary income is a way of curtailing that tax-exempt treatment.

The seemingly odd treatment of carried interest can actually be justified as a partial offset to the tax bias against saving and investment inherent in the income tax. In this regard, it is similar to the justification for retirement saving arrangements and accelerated depreciation.

The current tax system is a hybrid, its tax base a mix of income and consumption elements. The income tax treats saving and investment more harshly than consumption. Under the income tax, income is taxed when earned. If the after-tax income is used for consumption, there are few added federal taxes (only excise taxes on a few items). But if it is used for saving and investment, the returns generated by the saving are taxed as business income, capital gains, dividends, or interest (and a third time if there is a corporate tax, and potentially a fourth time by the estate or gift tax).

The basic tax bias is reduced to the extent we allow pension treatment for saving, either by deduction of the income that is saved and taxing the principal and earnings later when they are withdrawn, as in a regular IRA or pension, or taxing the saving when first earned but exempting the returns from additional tax, as with a Roth IRA or a tax-exempt bond. (The analogy for direct investment is to allow expensing – immediate write-off – instead of delayed depreciation over time.) The result (ignoring the corporate and estate taxes) is a "saving-consumption neutral" tax system.

Moving away from the income tax base toward a "consumption" or "consumed income" neutral base would increase the amount of capital that people are willing to accumulate. It would raise productivity, wages, employment, output, and living standards.

In a neutral tax system, investors in a partnership would get an up-front deduction for their capital contributions as soon as they are made, and then pay tax (at ordinary rates) on the earnings and the principal at a later date when the earnings are distributed and the capital is returned. Under current income tax rules, they get no up-front deduction for the capital contribution and pay tax on the excess of returns over their contributed amounts at a later date. In effect, the government allows them to deduct the capital contribution only later, against the revenues from the investments. This ignores the cost to the saver of the time value of money, and raises the effective tax rate on income used for saving compared to income used for consumption. The carried interest tax treatment that permits some of the return to get a favorable capital gains tax rate when it otherwise might not can be viewed as a partial offset to this income tax bias against saving.

Reduced access to foreign tax credits. One set of revenue offsets (tax increases) would reduce businesses' access to the foreign tax credit. The foreign tax provisions should be held back until such time as we can undertake a full reform of the United States international tax system including a reduction of the U.S. corporate tax rate.

Unlike most nations, the United States has a global tax system that taxes the foreign income of companies headquartered within its borders. To prevent double taxation, it then allows the companies a tax credit against foreign income taxes paid on the income earned abroad. In addition, it does not tax the foreign source income from a firm's active business until it is repatriated.

Multinational companies produce products and services using parts and labor from many countries, raise money in many jurisdictions, pay interest and dividends in a variety of places, and are subject to many types of foreign taxes. The Treasury and the firms are often in disagreement as to the size, nature, and location of revenues, costs, and profit subject to U.S. tax. The offsets being considered attempt to tie more closely the foreign income to the costs incurred in earning it, country by country. This may have merit in a narrow accounting sense, but it is hard to pin down.

One thing is certain, the changes will have the effect of making U.S. firms increasingly subject to higher tax rates than their foreign competitors, with less of an offset from the foreign tax credit. The U.S. corporate tax rate is the second highest among the developed nations. Reduced access to the foreign tax credit would place U.S. businesses at a further disadvantage relative to companies from other countries. As U.S. firms lose business abroad, they will ultimately have less income to repatriate. They will also contract here at home, because less U.S.-based production of multinational firms would be sent to their foreign affiliates. The tax provisions would yield less revenue than expected, especially if reduced U.S. activity were taken into account.

Higher employment taxes on some small businesses. Limited partners pay payroll and other employment taxes on payments received for services rendered. Partners in small businesses organized under Subchapter S pay employment taxes on actual compensation or "reasonable compensation" even if the earnings are not distributed. The provision would require persons providing significant "professional services" to the partnership to report the full share of their partnership income and that of their families to be subject to the payroll taxes, even if the income is not distributed. It would affect small businesses in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, athletics, investment advise or management, consulting, and brokerage services. It is apparently aimed at dentists, CPAs, and consultants who are deemed not to be reporting enough "wages" (as opposed to capital income) from their businesses to satisfy the tax authorities. The tax will limit reinvestment and expansion of these businesses.

Oil Spill Liability Trust Fund Excise Tax. The federal oil spill excise tax of eight cents per barrel (due to rise to nine cents in 2017, and then sunset in 2018) would be raised to 41 cents per barrel (versus

34 cents in the House bill). This tax will raise energy prices for consumers. Some of the added revenue would go to fund whatever portion of the Gulf of Mexico clean-up is not paid by the companies responsible. The amount of the revenue gain in excess of the federal share of the Gulf clean-up effort is supposed to boost the federal oil spill clean-up trust fund. It cannot honestly be said to boost that trust fund while also being used to pay for the spending portions of the legislation. This mischaracterization of the tax increase highlights the fact that federal trust funds are not real money; they are only promises to borrow or tax in the future to fund the earmarked purpose.

Health care and unemployment assistance, Title V

The "doc fix" would retroactively restore the higher level of Medicare reimbursement for physicians that expired at the end of May. Unrealistic health care cost containment formulas enacted several years ago would by now have imposed a 20% reduction in compensation to health care professionals under Medicare. Waivers and temporary increases reflecting rising costs of care had been enacted in recent years to forestall the cutbacks, but "doc fix" was omitted from the health care reform legislation last fall to make it appear less expensive. The fix is in the current extenders bill, which is running late, and the caps have now begun to bite. The current bill would retroactively provide another delay in implementation of the Medicare provider cost caps, and instead would increase payment rates by 1.3 percent for the rest of 2010 and 1 percent for 2011. An earlier version of the bill would have mandated a revised payment system beyond 2013 to produce less of a scheduled reduction in future payments, bringing the cost to $64.7 billion. To make this bill look less expensive, the current Senate version assumes an abrupt reversion to the lower payment schedule in 2014, reducing the apparent cost of the provision to $22.9 billion. This is smoke and mirrors.

The caps are not realistic, and should be amended on a permanent basis. Other federal spending should be reduced permanently to pay for the shift of resources to the health care programs. We cannot expect physicians, nurses, other health care workers, and the producers of health care materials and services to work for less than the cost of their time, education, and production costs.

The bill would extend the temporary 6.2 percentage point increase in the federal matching rate for the state-run Medicaid programs, and provide additional matching for states with high unemployment (FMAP). The bill dropped an earlier provision that would also have extend eligibility for the 65 percent subsidy of fifteen months of COBRA health insurance premiums for individuals who lose jobs before the end of this year. There are other miscellaneous health-related provisions.

Unemployment benefit extension. The bill would extend the full federal funding of additional tiers of unemployment compensation, up to 99 weeks of benefits, enacted earlier in the recession. The earlier version of the bill would have extended the benefit through December, 2010. The June 8th version extends the benefits through November, 2010, to make the bill look less expensive. Unemployment benefits are usually paid half by the states and half by the federal government. For the last two years, the two highest tiers of benefits have been covered entirely by the federal Treasury. The further extension of already unprecedented unemployment benefits may cause people to delay their jobs searches, but the current job market is very weak, and the extension looks inevitable. The situation cries out for more effective tax policies to revive private sector production and job creation.

Summer jobs. The bill contains money for teenage summer jobs programs. The teenage unemployment rate has been driven higher in part due to the recent increases in the minimum wage. Summer jobs money is not a good substitute for the permanent job opportunities that a sub-minimum wage or exemption for teenagers would provide. Nor is it a substitute for a healthier private sector and jobs market, which could better be attained through lower levels of federal spending and lower taxes on investment and earnings could provide.

Conclusion

The unemployment extension and "doc fix" should be enacted at once, because these provisions have expired and are holding up relief checks and medical payments. The rest of the bill should be sent back to Committee to be slimmed down, especially in the energy subsidy sections. The revenue offsets should be scrapped and replaced by spending reductions. The key extenders should be made permanent. The medical payments adjustments should be passed, and then settled on a permanent basis in follow-up legislation revamping federal involvement with health care. The annual extenders process should cease to be a means of ratcheting up the level of taxes.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.