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FALSE CHARGES OF CORPORATE WELFARE FUEL ADMINISTRATION TAX HIKE PROPOSALS

The Clinton Administration's budget submission for fiscal year 1997 includes a number of proposed tax increases, along with several much more publicized provisions to reduce taxes. The Administration claims that the majority of its revenue raisers are simply intended to curb excessive business tax breaks. "The President's plan cuts unwarranted corporate tax subsidies, closes tax loopholes, improves tax compliance and adopts other revenue measures. These reforms ... are estimated to save $43.6 billion during the 7-year period, 1996-2002..."[1]

One problem with the Administration's characterization of its plan as a $43.6 billion saving is that *taxpayers* would not "save" on the deal; they'd be bearing higher tax costs in order for the government to collect additional revenue. A more fundamental problem with the Administration's sanguine assessment is that most of the tax hikes sought by the Administration would worsen tax biases against saving and investment.

[M]ost business tax "loopholes" ... mitigate — but do not eliminate — tax penalties against saving and investment. Retaining or even expanding these "breaks" is thus called for by sound tax principles.

The Administration's defense of its revenue raisers relies on the notion that corporations enjoy a wide assortment of tax breaks, causing their taxes to be too low. A leading advocate within the Administration of this position is Labor Secretary Robert Reich, who has spoken often of "corporate welfare," implying that the tax treatment of businesses is somehow analogous to the benefits some people receive through means-tested welfare programs. Nor is this view confined to the

[1] Office of Management and Budget, *Budget Of The United States Government, Fiscal Year 1997: Analytical Perspectives* (Washington: DC, Government Printing Office, 1996).

Institute for Research on the Economics of Taxation

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Administration. Mindful of Reich's phrasing, several members of Congress recently introduced the "Corporate Welfare Reduction Act" (H.R. 1278), which would increase federal taxes on the foreign income of individuals and businesses by more than $23 billion over 5 years. In the Republican Congressional leadership, House Budget Committee Chairman Rep. John Kasich (R-OH) has stated that tax reductions could be financed in part by closing various corporate tax "loopholes", among them the section 936 possessions tax credit[2]. A bill to soften the tax burden on small businesses (H.R. 3448) also targets section 936, with repeal of section 936 financing most of that bill's revenue losers. The Congressional Budget Office (CBO) claimed in a 1995 study that the tax code affords extensive "federal aid to business."[3]

If these claims are believed, the federal government has a revenue source at its fingertips that it can easily tap without harming the economy or imposing undue burdens on taxpayers. That sounds too good to be true, and it is.

The basic mistake of critics of business tax "breaks" is using as their normative standard a tax structure that is sharply tilted against saving and investment.

On inspection, most business tax "loopholes" turn out to be nothing of the sort. The majority of "loopholes" mitigate — but do not eliminate — tax penalties against saving and investment. Retaining or even expanding these "breaks" is thus called for by sound tax principles. Repealing these "breaks" would <u>worsen</u> the anti-saving, anti-investment tax biases. The basic mistake of critics of business tax "breaks" is using as their normative standard a tax structure that is sharply tilted against saving and investment. Compared to that distortionary benchmark, tax provisions that are somewhat less biased against saving and investment are falsely categorized as loopholes.

An earlier IRET evaluation of the CBO's study uncovered this mistake.[4] The CBO started by assuming that the biased standard on which it relied was neutral and then took deviations from that distortionary benchmark as evidence of tax subsidies.[5]

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[2] "Talking Points on the Fiscal Year 1997 House Budget Resolution," reprinted in *Daily Tax Report*, pp. L-33 to L-36, May 9, 1996.

[3] Congressional Budget Office, *Federal Financial Support Of Business*, 1995.

[4] See Michael Schuyler, "CBO Grossly Overstates Business Tax Subsidies," IRET Congressional Advisory No. 48, 1995.

[5] The CBO says, "The government [directly] supports business through spending programs, credit activity, and tax preferences." Because the CBO's reference point with regard to taxes is biased, it judges that tax breaks are the largest of these, accounting "for the bulk of federal efforts to promote business." (*CBO Report*, op. cit., p. 17.) Measured against a neutral tax system, however, current tax law generally penalizes businesses rather than

An examination of the Administration's proposed tax hikes reveals the same error. The examination also finds that although the Administration claims several of its recommendations would simplify the tax code, they would actually add yet more complexity. Further, several of the proposals do not concern corporate taxation but taxation at the individual level. In contrast to the Administration's suggested tax cuts, its revenue raisers involve areas of the tax code that are largely hidden from voters. That is good politics, but it interferes with the important role of taxes as a means of letting citizens know how much they have to pay for government services.

Because most of the Administration's proposals deal with highly technical issues and because the Administration's shopping list of revenue raisers is long, the evaluations that follow do not address all of the provisions in the Clinton Administration's plan, but they cover enough of them to make abundantly clear the errors in the Administration's analytical framework.

<u>Prohibit corporations from deducting interest payments on loans collateralized by corporate owned life insurance (COLI)</u>

Corporations may buy insurance policies on the lives of their employees. When corporations use these policies as collateral in obtaining loans, they may, subject to some restrictions, deduct their interest payments on the loans. Lenders, of course, must include those interest payments in their taxable incomes.

With regard to the deductibility of interest expenses on borrowings secured by COLI policies, what the Administration ignores is that lenders <u>do</u> pay tax on the interest they receive from policy loans. Thus, if corporate borrowers could not deduct their interest costs...the <u>same</u> income would be <u>taxed twice</u>.

The Administration asserts that the combination of the tax treatment of life insurance policies and the deductibility of interest payments on loans secured by the policies is a "tax-arbitrage opportunity"[6]. The Administration's proposal is to bar corporations from claiming this interest deduction.

When corporations own life insurance policies, they are treated by the tax code in a similar fashion to other holders of life insurance policies. Although the government has long contended that the standard tax treatment of life insurance policyholders is a "tax expenditure", careful analysis

supporting them. Government spending and credit programs are where most government aid to selected industries and companies can be found.

[6] *FY '97 Budget, op. cit.*

demonstrates that the tax treatment of life insurance policies is very close to being neutral between saving and consumption.[7]

With regard to the deductibility of interest expenses on borrowings secured by COLI policies, what the Administration ignores is that lenders do pay tax on the interest they receive from policy loans. Thus, if corporate borrowers could not deduct their interest costs on COLI-backed loans, the same income would be taxed twice. Corporate borrowers would have to include it in their income tax bases, and lenders would also have to pay income tax on the interest. For instance, if a business uses $5,000 of its earnings to pay interest on COLI-backed loans, both the business and the lender who receives the payment would have to include the same $5,000 in their taxable incomes under the Administration's proposal. Hence, allowing corporations to deduct their interest payments on loans backed by life insurance policies is not a subsidy; it is needed merely to avoid taxing two different taxpayers on the same income.

In its argument, the Administration neglects to consider the income tax paid by the lender and instead makes the factually incorrect statement: "The interest that the company [owning a COLI policy] pays on policy loans is credited under the contract and increases the tax-free inside buildup... Large COLI programs may be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself interest."[8] Again, it is the lender who gets the interest, not the policyholder. The tax code currently recognizes this fact by including the interest payments in the lender's tax base (along with earnings the lender may receive on other investments like real estate, corporate bonds, government securities, stocks, etc.), and not also including the interest payments in the borrower's tax base.

The Administration's proposal also raises the troubling issue of retroactive taxation (as do several of the Administration's other proposals). With only a brief and limited phase in, the elimination of the interest deduction would apply to interest charges on already existing loans. Beyond its unfairness, retroactive taxation is undesirable because the danger of after-the-fact taxation increases the riskiness of saving and investing. That leads to less saving and investment than otherwise, which slows economic growth.

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7 By the government's reasoning (long predating the current Administration), life insurance policyholders (millions of individuals and some businesses) are subsidized because they are not required to pay income tax each year on any increase in the cash value of their policies and do not normally pay tax on death benefits. For a thorough examination of why basic tax principles support the current tax treatment of policyholders, see Michael A. Schuyler, *Tax Treatment Of Inside Buildup In Life Insurance Products*, IRET Fiscal Issue No. 9 (Washington, DC: Institute for Research on the Economics of Taxation and Savers & Investors League, 1994).

8 *Treasury Department General Explanation of Revenue Proposals in Administration's FY 1997 Budget Proposal*, reprinted in *Daily Tax Report*, March 19, 1996, pp. L-1 to L-53.

Deny interest deduction on corporate bonds with a maturity of over 40 years and on certain other debt instruments

The Administration urges that corporations not be allowed to deduct interest payments on bonds they issue that have maturities of over 40 years.

Like the COLI provision, this is an attack on the deductibility of interest payments. If implemented, the government would be taxing two different taxpayers on the same income. Corporations issuing bonds with maturities of over 40 years and some other types of debt instruments would have to include what they pay in interest in their taxable incomes. The lenders receiving the interest payments would also have to pay tax on them.

The Administration defends its proposal by observing that debt issuers can deduct interest payments from their taxable incomes whereas equity issuers cannot deduct dividends. The Administration frets, "The line between debt and equity is uncertain... Taxpayers have exploited this...by issuing instruments that have substantial equity features, but for which they claim interest deductions."[9]

The Administration urges that corporations not be allowed to deduct interest payments on bonds they issue that have maturities of over 40 years. Like the COLI provision, this is an attack on the deductibility of interest payments. If implemented, the government would be taxing two different taxpayers on the same income.

Actually, the exploiter here is the government. First, the debt or equity character of an instrument does not depend on the length of the instrument's term. The characteristics that distinguish a security as debt have nothing to do with its term to maturity. The Administration's contention that securities become equity by virtue of a long term to maturity is blatantly counterfactual. If the Administration's peculiar theory were correct, 30-year Treasury securities and corporate bonds would be almost equity due to their long lives (30 years is not much shorter than 40 years). At one time 100-year private bonds were common, and governments sometimes issued perpetual securities, which promised to pay interest in perpetuity without ever being redeemed, but no one ever confused those extremely long-lived debt instruments with equity.

More fundamentally, the Administration assumes that the current tax treatment of corporate equity accords with sound tax principles. Actually, it leads to two levels of income tax on the same income: the government taxes earnings at the corporate level and taxes the same earnings a second

[9] *FY '97 Budget, op. cit.*

time when they are realized by individual shareholders as dividends or capital gains. To avoid these two rounds of tax, and the bias against corporate equity investments they generate, the earnings should not be taxed at both the corporate and individual levels. Subjecting corporate debt to the same two-taxes-on-the-same-income tax treatment as corporate equity would be a terrible step backwards in terms of sound tax principles.

Beyond its worsening of tax biases, the Administration's recommendation would add complexity and capriciousness to the distinction between debt and equity.

Reduce dividend received deduction to 50 percent

Under current law if one corporation owns stock in another corporation, the corporation owning the shares can exclude a portion of the dividends it receives from its taxable income. The exclusion is 70 percent if the ownership stake is less than 20 percent, 80 percent if it is between 20 and 80 percent, and 100 percent if the ownership stake is greater than 80 percent. Although corporations with an ownership stake of less than 20 percent already have the smallest exclusion, the Administration declares that it is still "too generous" and seeks to cut it down to 50 percent.[10] The Administration would also effectively lower the deduction by tightening the holding period requirements corporations must satisfy in order to claim the deduction.

To prevent the cumulative income tax rate at the corporate level from rising above 35 percent when one company owns a stake in another, the dividend received deduction should be raised to 100 percent... The Administration, however, would move in the opposite direction and cut the already inadequate dividend received deduction.

The deduction is based on the government's (limited) recognition that the same income should not be taxed repeatedly. For example, suppose that Company C owns shares in Company B and Company B owns shares in Company A. If there were no dividend received deduction, $1 earned by Company A and paid successively to Companies B and C as dividends would be reduced to 27.5 cents after each of the three companies had paid tax on it — a cumulative corporate tax rate of 72.5 percent. (When paid to individual shareholders of Company C, the individual income tax would take a further bite, reducing the after-tax income to 16.6 cents for a shareholder in the 39.6 percent bracket — raising the total tax rate to 83.4 percent.)

In applying this principle that the same income should not be taxed repeatedly at the corporate level, it is irrelevant whether the corporation receiving the dividends owns a large or small stake in

[10] *FY '97 Budget, op. cit.*

the corporation issuing the dividends. The recipient should not pay tax on already-taxed dividend income regardless of whether its stake in the issuing corporation is 100 percent, 50 percent, 10 percent, or 1 percent. Current law violates this principle when it penalizes companies with ownership shares below 80 percent and compounds the error when it stiffens the penalty for corporations with ownership shares below 20 percent. By slashing the dividend received deduction to 50 percent when the ownership stake is below 20 percent, the Administration would take a mistaken idea and make it worse.

The dividend received deduction had been 85 percent prior to the Tax Reform Act of 1986, which cut it to 80 percent. The official explanation of the 1986 change was deficient in two respects. First, it said that although the 1986 legislation aimed to lower statutory tax rates, "The Congress did not believe that the reduction in corporate tax rates generally should result in a significant reduction in this effective rate [on dividends paid by one corporation to another]."[11] That is not really an explanation, however, because it begs the question of what, if any, justification Congress had for singling out inter-corporate dividends and effectively taking some of the corporate rate reduction away from them by making a larger share of inter-corporate dividends subject to tax. Second, the official explanation was deficient because it discussed the taxes paid by corporations receiving dividends in isolation from the taxes already paid on those same dividends by the issuing corporations. That incomplete view misses the whole purpose of a dividend received deduction, which is to prevent the corporate income tax from taxing the same income again and again if the income passes through multiple corporations via dividends. The flaws in the official explanation suggest that Congress's real motivation was finding revenues. Tax legislation in 1987 further chopped the dividend received deduction to 70 percent.

To prevent the cumulative income tax rate at the corporate level from rising above 35 percent when one company owns a stake in another, the dividend received deduction should be raised to 100 percent. That would not be a tax subsidy but a means of preventing the same income from being taxed again and again at the corporate level. Even if the dividend received deduction were 100 percent, dividends would still be subject to two rounds of income taxation: one at the corporate level and a second at the individual level. Thus, dividends would still be overtaxed. The Administration, however, would move in the opposite direction and cut the already inadequate dividend received deduction. That would produce greater overtaxation.

Require asset owners to use average cost basis in computing capital gains on stocks, bonds, and other securities

Under current law, an investor who owns multiple shares of a security and sells some of them can use the actual cost of the shares which have been sold in computing capital gains tax. The U.S. Treasury, however, asserts this is "artificial and complex."[12]

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[11] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 1987.

[12] *Treasury Explanation, op. cit.*

In the Administration's plan, owners of multiple shares of a security who sell some of them would have to pretend that the cost of those shares is a blended average of the cost of all such shares, both sold and unsold. Contradicting its demand that sold and unsold shares be averaged in computing cost, the Administration would require use of the first-in, first-out method in computing how long the shares sold had been held. This is one of the provisions in the Administration's budget that targets individual asset owners and investors in blatant disregard of tax principles.

If investors sell specific shares, it is hardly a tax break for them to be able to show the gain or loss...on <u>those</u> shares [in computing capital gains]... The Administration would outlaw a factually accurate method of reporting cost basis in favor of another method that often yields lower reported costs and, hence, higher taxes.

Compared to current law, it is the Administration's plan that is "artificial and complex." If investors sell specific shares, it is hardly a tax break for them to be able to show the gain or loss they realized on <u>those</u> shares. The Administration's real objection seems to be that because current law allows asset owners to choose among several options in computing the cost of shares sold, asset owners can better "plan and control the amount of gain or loss they will recognize."[13] The Administration would outlaw a factually accurate method of reporting cost basis in favor of another method that often yields lower reported costs and, hence, higher taxes.

The Administration's contention that its proposal would primarily affect sophisticated investors also does not make current law a tax break. Tax subsidies should be measured by how current law treats taxpayers relative to how a neutral tax system would treat taxpayers, not by the experience level of taxpayers. The Administration's use of the sophisticated-investor argument to justify a tax hike suggests it is confusing "soak-the-rich" tax policies with principled tax policies. Further, because a heavier capital gains tax weakens the economy, the harm caused by the tax increase would affect everyone, not just capital asset owners.

Beyond lacking justification in fact, the Administration's proposal would compound a tax penalty. Capital gains are already taxed too heavily. One problem is that the investor's basis in his or her capital asset is measured without adjusting for inflation, which means that real gains in inflation-adjusted dollars are much smaller than the nominal gains used in computing the capital gains tax. A more subtle but fundamental source of overtaxation is that because security values are based on the discounted value of expected future earnings and capital gains reflect changes in that expected earnings stream, taxing both future earnings and the capital gains stemming from those earnings amounts to taxing the same income twice. If the future earnings are taxed, the government

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[13] *Treasury Explanation, op. cit.*

should not also tax changes in the discounted value of those future earnings. Moreover, insofar as the expectation of increased future earnings results from the corporation's retaining and reinvesting some of its after-tax current earnings, the multiple taxation of these earnings is compounded.

Because the capital gains tax is widely recognized to be a drag on saving, investment, and entrepreneurship, as well as an excessive tax on asset owners, there are frequent calls for reducing it. As a bonus, many studies have indicated that a lower capital gains tax rate might actually boost government revenues by leading to more asset sales, higher asset values, and a more productive economy. The Administration's proposal goes in exactly the wrong direction. The Administration's budget plan also has several other provisions that would increase the capital gains tax rate in certain cases.

Shorten the carryback period on net operating losses (NOLs)

Under current law, businesses owe taxes if they earn profits but do not receive government checks if they suffer losses. They can, however, carry current-year losses back up to 3 years to reduce taxes they paid in previous years and carry losses forward up to 15 years to reduce taxes they will owe in future years. Carrybacks and carryforwards of net operating losses (NOLs) are not tax loopholes but means of letting businesses offset losses to a limited extent against profits when calculating their taxes. A better netting of losses and gains over the life of a business would occur, of course, if the carryback period were not so short.

The Administration, however, wants to shorten the carryback period further and claims it is just trying to simplify the tax code. In the Administration's words, "[T]he carryback period should be shortened" to only one year because of the "complexity and administrative burden associated with carrybacks."[14] Perhaps to give the appearance of being evenhanded, the Administration would lengthen the carryforward period to 20 years because that can be done "without increasing either complexity or administrative burdens."[15]

Carrybacks are more helpful to companies with losses than carryforwards because carrybacks reduce taxes immediately while carryforwards delay any reduction in taxes.[16] Because future dollars are worth less than current dollars, the delay associated with carryforwards reduces to less than its original amount the present value of an NOL that cannot be claimed until some future year. For

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[14] *FY '97 Budget. op. cit.*

[15] *FY '97 Budget. op. cit.*

[16] With carrybacks, companies can net their current losses against income from prior years. This de facto income averaging reduces the companies' taxable incomes for the prior years and lets them obtain refunds on some of the taxes they paid in those prior years. With carryforwards, companies must wait until future years when they have positive taxable incomes and then net their losses against their future incomes. This netting reduces the companies' future taxes below what they would be otherwise — provided the companies have positive incomes in the future so they can use the carryforwards.

example, if a one dollar NOL in the current year can be claimed as a carryback to a year in which income was realized, tax on a dollar of income in the prior year can be recovered without delay. That means the value of the NOL does not have to be discounted. On the other hand, if the NOL must be carried forward, say, 15 years and the discount rate is, say, 10 percent, the discounted value of the one dollar NOL is only 24 cents.

Carrybacks and carryforwards of net operating losses (NOLs) are not tax loopholes but means of letting businesses offset losses to a limited extent against profits when calculating their taxes... By denying or delaying the recognition of many losses because current NOLs could no longer be counted against income from two or three years earlier, the Administration's proposal...is a revenue grab that would enrich the government at the expense of businesses experiencing losses.

Given that the Administration nowhere contends that the current carryback period is a tax subsidy, it is surely deceptive to include it among alleged subsidies and loopholes. Moreover, an internal contradiction emphasizes the implausibility of the Administration's stated rationale for changing current law. The Administration claims that current law's short carryback period is unacceptably complicated, but it also claims that a five-year lengthening of the already long carryforward period would not increase complexity in the slightest.

The Administration's proposal would encourage tax-driven mergers. Suppose a shorter carryback period prevents a company from claiming NOLs it otherwise could use. That would create a tax incentive to merge with a profitable company because a merger would allow the NOLs to be put to use immediately. (The NOLs could offset the profitable company's current income.)

The Administration's proposal to shorten the carryback period while lengthening the carryforward period is anything but evenhanded. It is punitive. By denying or delaying the recognition of many losses because current NOLs could no longer be counted against income from two or three years earlier, the Administration's proposal would effectively increase the tax rates of many businesses suffering losses. It is a revenue grab that would enrich the government at the expense of businesses experiencing losses.

<u>Treat certain preferred stock as "boot", which would cause more corporate reorganizations to trigger immediate taxes on shareholders</u>

In corporate reorganizations, the receipt of stock generally does not require shareholders to recognize gain (or loss). For example, if a corporation wants to spin off a subsidiary and issue stock in the new company to shareholders in the parent company, that is not a taxable event, and the shareholders who receive the new shares do not have to pay tax on them until they sell them. On the other hand, if the shareholders receive "boot" (property other than stock, in this case), they generally are subject to immediate taxation.

The Administration seeks to recategorize certain preferred stock as "boot" (non-stock property) in this one section of the tax code. The change would force those who receive certain preferred stock in a corporate reorganization to pay taxes as a direct result of the reorganization. In rationalizing its recommendation, the Administration insists that preferred stock is not really stock "because preferred stock has an enhanced likelihood of recovery of principal or of maintaining a dividend or both..."[17]

The Administration's attempt to deny in this one section of the tax code that preferred stock is stock is wholly without merit... If the government succeeds in throwing another hurdle in the path of corporate reorganizations...the result will be a less flexible, less innovative, and less competitive U.S. economy.

The Administration's attempt to deny in this one section of the tax code that preferred stock is stock is wholly without merit. Preferred stock is generally recognized as a category of stock. It has features that distinguish it from common stock, but those features have a very long history and do not suddenly cause preferred stock to cease to be stock. Further, if the Administration were sincere in the belief that preferred stock is not stock, it would extend its reclassification to preferred stock dividends. Businesses cannot deduct preferred stock dividends, but if the government reclassified preferred stock as debt throughout the tax code (the Administration suggests in its quote that preferred stock ought to be equated to debt), businesses could deduct their preferred stock dividends. Of course, the Administration proposes nothing of the sort; the reclassification it wants is strictly heads the government wins, tails the taxpayer loses.

The Administration would not be closing a tax loophole here but taking advantage of taxpayers. The Administration's proposal would also be bad news for the economy. Spinoffs and other corporate reorganizations are important to the economy because they help businesses operate more efficiently, and that leads to a more vibrant and competitive economy. If the government succeeds in throwing another hurdle in the path of corporate reorganizations, it will prevent some of them from being undertaken. The result will be a less flexible, less innovative, and less competitive U.S. economy.

Treat conversions from C corporations to S corporations as taxable events

Under tax code section 1374, a C corporation can convert into an S corporation without triggering taxes. (If the S corporation sells assets that it holds at the time of the conversion within

[17] *FY '97 Budget, op. cit.*

10 years, though, it must pay tax on the assets' built-in gain.) The Administration's desire is to treat the conversion as a total liquidation of the C corporation if the C corporation's value exceeds $5 million. That would make the conversion a taxable event at both the corporate and shareholder levels. At the corporate level, capital gains tax would be due on all assets within the corporation that had appreciated in value. At the shareholder level, capital gains tax would be due on any appreciated value in the shares of the company.

The Administration's proposal [to tax conversions of C corporations to S corporations] would lock many businesses into two levels of tax on the same income... [That] does not address a tax loophole but seeks to protect egregious overtaxation.

Corporate earnings are normally taxed at the corporate level and again at the individual level. The incomes of S corporations, however, are imputed directly to shareholders. Thus, the earnings of S corporations are taxed at the individual-holder level but not at both the corporate and individual levels. The Administration refers to this when it says, "A corporation can avoid the existing two-tier tax by electing to be treated as an S corporation..."[18] Substituting a single level of tax for two levels of tax, though, is hardly a tax break but a move towards less onerous taxation. Indeed, from the perspective of good tax principles, the single-level tax on S corporation earnings could serve as a model for how all corporate earnings ought to be treated.

The Administration's only defense of its proposal is that "The tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership."[19] Under current law, a conversion from a C corporation to a partnership is treated as a complete liquidation of the C corporation. Instead of being a good model, though, this is a very bad model. First, it is artificial to regard a going business as being completely liquidated merely because it converts from one form of organization to another. Second, capital gains taxes come due if the conversion is treated as a liquidation, and capital gains taxes are excessive. (This was discussed earlier in evaluating the Administration's recommendations for increased capital gains taxation.) Third, capital gains taxes are doubly inappropriate in this case. When assets held by a business appreciate in value, that tends to be reflected in higher share prices. Thus, taxing asset appreciation at the business level and share appreciation at the shareholder level often subjects the same appreciation to <u>two</u> capital gains taxes. Rather than patterning the tax treatment of conversions to S corporations on the tax treatment of conversions to partnerships, conversions to partnerships ought to be treated like conversions to S corporations.

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[18] *FY '97 Budget, op. cit.*

[19] *Treasury Explanation, op. cit.*

The Administration's proposal would lock many businesses into two levels of tax on the same income. It would do this by, in effect, taking as hostage the businesses' appreciated assets. Thus, the Administration's idea does not address a tax loophole but seeks to protect egregious overtaxation.

Further restrict the ability of taxpayers to use foreign tax credits

Most countries tax their businesses on income earned in those countries but not on income earned elsewhere (territorial approach). The United States, in contrast, requires its individuals and businesses to pay tax on their worldwide income. The worldwide approach exposes U.S. taxpayers to two taxes on the same foreign source income: tax in the country where the income is earned and tax in the U.S. To deal with this particular double-tax problem that results from worldwide taxation, the U.S. provides a foreign tax credit (FTC), which allows U.S. taxpayers to subtract their foreign tax payments from their U.S. tax liabilities on their foreign-source incomes.

The amount a taxpayer can claim in FTCs, however, is limited to the U.S. tax on its foreign source income. For example, if a U.S. business has $1,000 of foreign source income, the maximum amount of FTCs it can claim against U.S. taxes is $350 (assuming the business has a U.S. tax rate of 35 percent).

To enforce this limitation on using FTCs, the U.S. has adopted rules for allocating receipts, expenditures, and, thus, income among domestic and foreign sources. Over time the rules have become increasingly complex and arbitrary as Washington has added a multiplicity of restrictions in order to raise more revenue. The rules now break down income into many different categories and do so on a country-by-country basis, with a separate limitation on using FTCs in each of these subcategories. Taxpayers often complain that the government's allocation rules and the breakdown of foreign source income into so many baskets, each with its own separate limitation, systematically understate foreign source income and artificially limit use of FTCs. In consequence, say many U.S. taxpayers, they frequently have FTCs they cannot use (excess FTCs) and experience double taxation on some of the income they earn abroad.

For instance, suppose a U.S. business has $1,000 of foreign source income on which it pays $350 of foreign taxes. If the U.S. tax system's allocation rules count only $800 of that income as foreign, the business could only use $280 of its FTCs (35 percent of $800) and would have $70 of excess FTCs (35 percent of $200). Thus, the U.S. allocation rules would effectively double tax the business on $200 of its foreign income: the business would have to pay U.S. tax on that income without being able to subtract the $70 of foreign taxes it had already paid on that income. Similarly, suppose the U.S. rules force the same business to divide its $1,000 of foreign income into two baskets of $700 and $300 while dividing foreign taxes evenly between the baskets ($175 in each basket). With the first basket, the business's FTC limitation would be $245 (35 percent of $700), and it could claim the $175 of FTCs in that basket. With the second basket, however, the business could only claim $105 of FTCs (35 percent of $300), leaving it with $70 of excess FTCs and, effectively, $200 of foreign income on which it would be double taxed.

Several Administration proposals would further limit the use of FTCs, exposing more foreign source income of U.S. individuals and businesses to double taxation. One of the Administration's proposals is to shorten the carryback period on excess FTCs and lengthen the carryforward period. The Administration insists it is merely trying to simplify the tax code. As discussed with the Administration's similar proposal regarding NOLs, a shorter carryback period would not simplify the tax code and does not address a tax loophole. It would increase the taxes of many U.S. individuals and businesses, worsening the double taxation of their foreign source income.

Over time the [foreign tax credit (FTC)] rules have become increasingly complex and arbitrary as Washington has added a multiplicity of restrictions in order to raise more revenue... Several Administration proposals would further limit the use of FTCs, exposing more foreign source income of U.S. individuals and businesses to double taxation.

Another Administration proposal would deny FTCs to oil and gas extraction companies on income taxes they pay in countries where most individuals and businesses in those countries do not pay income taxes. (These foreign taxes could only be claimed as deductions, which have much less value than credits.) In other words, where foreign governments apply income taxes only to oil and gas extraction companies and other selected taxpayers, this provision would force the U.S. companies to pay income taxes on the same income to both the foreign government and the U.S. This provision would also create yet another basket, with its own special limitation, on the use of FTCs. By increasing the double taxation of the income of U.S. oil and gas extraction companies that operate abroad, this provision would discriminate against those companies and weaken their competitiveness relative to foreign firms not burdened with this double tax.

Another provision would pertain to a U.S. company which, under the terms of the 1986 tax act, can allocate its interest expense in computing foreign source income on a subsidiary-by-subsidiary basis. This option is also open to financial institutions but not to most nonfinancial corporations. The Administration would require the company to consolidate interest expense over all subsidiaries, which in this case would decrease the company's useable FTCs, increase its excess FTCs, and raise its U.S. tax bill. Although the Administration's proposal concerns a special rule, there is no evidence that the parent company or its subsidiary companies have rearranged their finances after the rule was adopted in 1986 to exaggerate their foreign source incomes or otherwise used the rule to misrepresent their foreign source incomes.

<u>Further restrict section 936 possessions tax credit</u>

Section 936 of the tax code has been instrumental in transforming Puerto Rico from one of the poorest Caribbean islands to the most prosperous. Originally enacted in the early 1920s to enhance the competitiveness of American businesses in the Philippines (then a U.S. possession), section 936 has allowed qualifying mainland corporations to pay possessions' taxes on their possessions income without also paying U.S. tax on that income. In the late 1940s, the governor of Puerto Rico realized that section 936 enabled the island to offer low tax rates as a powerful incentive in attracting U.S. businesses. Businesses gained by paying low Puerto Rican taxes instead of high federal taxes, and Puerto Rico gained by obtaining a large inflow of investment dollars, new business enterprises, and additional employment. Of course, the job gains are not measured only by the number of people employed by the possessions corporations in Puerto Rico. Many additional businesses and jobs on the island are created to provide services to the possessions corporations, and still more businesses and jobs depend on the added spending power of those employed by these corporations and their local suppliers. A substantial share of the Puerto Rican economy relies on the business and employment generated by section 936.

Section 936 can be thought of as the granddaddy of enterprise zones, and it has been a tremendous success. Section 936 also applies to business operations in certain other U.S. possessions, but it has been of particular importance in Puerto Rico.

If not for section 936, possessions corporations in Puerto Rico would have to pay federal tax on their Puerto Rican income, with only a deduction for Puerto Rican tax (the arrangement that applies in the 50 states). Section 936 allows what is known as tax sparing. Tax sparing is common under the tax systems of many nations. Indeed, it is automatic under the territorial approach to taxation, which many nations use. If the U.S. system of worldwide taxation is accepted as the correct tax model, though, section 936 is a tax subsidy.

A substantial share of the Puerto Rican economy relies on the business and employment generated by section 936... [A]nother scaling back [of section 936] should not be undertaken without weighing carefully the impact it would have on the Puerto Rican economy and how that would relate to U.S. policy objectives.

This does not necessarily imply that section 936 is unwarranted, however. Politically and socially, the United States has a strong interest in promoting a prosperous and stable Puerto Rico. By greatly expanding opportunities on the island, section 936 has been an enormously effective tool in doing that.

Use of section 936 was restricted as part of the Tax Equity and Fairness Reform Act of 1982, a large tax increase enacted that year. Section 936 was further limited by the Tax Reform Act of 1986 and restricted a third time by the Omnibus Budget Reconciliation Act of 1993. These changes have diminished the ability of low Puerto Rican taxes to attract and hold U.S. businesses. Yet another scaling back should not be undertaken without weighing carefully the impact it would have on the Puerto Rican economy and how that would relate to U.S. policy objectives. Unfortunately, the

Administration refuses to admit the conflict between these objectives and federal tax revenues. It attempts to deny the obvious by claiming that its proposed cutback in section 936 would "provide a more efficient tax incentive for the economic development of Puerto Rico and other possessions..."[20] Realistically, its proposal would hurt the Puerto Rico economy, not help it.

Modify depreciation schedules under the income forecast method

The income forecast method is a specialized way of calculating capital cost recovery schedules that is mainly used with motion pictures, video tapes, sound recordings, and similar depreciable property. Under this method, year-by-year income from the property is estimated, and each year's depreciation rate is based on the percentage of the property's total income expected to be received that year.

The Administration has noted that some income is excluded in computing the depreciation schedule (e.g., sale of movies to television after exhibition in theaters) and that the excluded income tends to occur relatively late in the property's life. The Administration proposes to use a more comprehensive estimate of income in calculating the cost recovery schedule that would generally slow down the rate at which taxpayers using the income forecast method can recognize their capital costs.

An implicit Administration assumption is that capital cost recovery should be synchronized with income generation. Doing this, however, delays recognition of expenditures for tax purposes, and that delay means that the present value of the cost recovery allowances falls short of capital outlays. This, obviously, creates a bias against investment. For neutrality, taxpayers must be able to write off their capital expenditures when they make those expenditures (expensing) or use a cost recovery system with the same present value as immediate write off. Because of the fact that a dollar tomorrow is worth less than a dollar today, the sum of extended write offs equal in absolute amount to capital expenditures is smaller in *discounted* dollars than actual capital outlays. For example, suppose a business buys a $1,000 capital asset and must write it off ratably over the next ten years. If the discount rate is 10 percent, the write offs total only $676 in discounted dollars; that understates the asset's true cost by $324. This understatement of the asset's cost in discounted dollars overstates income in discounted dollars and leads to excessive taxation. The income forecast method may be better than ordinary depreciation in some cases, but it is too slow to be neutral. Stretching it out by aligning it with an expanded estimate of future income would increase the anti-investment bias.

The Administration's proposal also includes an extremely complicated "look back" feature, requiring taxpayers to keep track of how actual revenues compare with estimated revenues and to pay or receive interest if actual and estimated revenues do not match. Although the Administration argues (implausibly) that many of its recommendations are designed to simplify the tax code, this feature would certainly be a dramatic move in the opposite direction.

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[20] *FY '97 Budget, op. cit.*

Permanently extend the 10 percent "luxury" tax on passenger automobiles

Rarely has a tax been more explicitly targeted at "soaking the rich" than the 10 percent "luxury" tax included in the 1990 budget deal. The tax's chief victims proved to be the mainly middle class people who worked in the taxed industries, many of whom lost their jobs when sales plummeted following the tax's enactment. Because of the tax's cost in terms of lost sales and lost jobs, along with its consequent ineffectiveness as a revenue raiser, it was repealed in 1993 on all items except passenger automobiles. That last vestige of the tax is scheduled to expire in 1999.

The Administration seeks permanently to extend the "luxury" tax. It claims to be concerned that "the scheduled expiration of the tax will substantially depress sales of automobiles subject to the tax for several months prior to its expiration."[21]

If the Administration were sincere in the desire not to depress automobile sales, however, it would propose repealing the ["luxury"] tax immediately... not extending the tax forever... That the Administration has included this class-warfare tax among its $43.6 billion of "reforms" to "eliminate unwarranted benefits and adopt other revenue measures" reinforces the impression that the Administration is not making a good-faith effort to identify tax breaks but is rather using that label as a handy excuse for proposing a long list of tax hikes.

If the Administration were sincere in the desire not to depress automobile sales, however, it would propose repealing the tax immediately (that would lead to higher sales from now through 1999), not extending the tax forever. Further, the expiration of the "luxury" tax in 1999 (meaning it will continue to be charged until then) is hardly a tax subsidy to automobile buyers or those working in the automobile industry. It is, instead, a tax penalty on them that will continue through 1999. That the Administration has included this class-warfare tax among its $43.6 billion of "reforms" to "eliminate unwarranted benefits and adopt other revenue measures" reinforces the impression that the Administration is not making a good-faith effort to identify tax breaks but is rather using that label as a handy excuse for proposing a long list of tax hikes.

Conclusion

It is very appealing politically to claim that tax increases are aimed at tax subsidies. If the charge is true, it implies that the taxpayers who would have to pay more are not being excessively burdened. If the revenue raisers would just remove tax favors for certain activities or products, it also implies that the revenue raisers would impose virtually no overall cost in terms of weakening the economy's

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[21] *Treasury Explanation, op. cit.*

performance. To determine whether tax provisions are subsidies, however, they must be compared to a neutral tax system that neither favors nor discriminates against the activities and products in question. When that is done, very few business tax "breaks" or other tax provisions dealing with saving and investment prove to be subsidies.

The Administration has put forward a long list of highly technical ways in which it seeks to boost taxes under the banner of closing corporate and other tax loopholes. An examination of the Administration's recommendations makes it abundantly clear that most of the "unwarranted benefits" the Administration attacks should, if anything, be expanded, not restricted. They help reduce tax biases against business income and other investment income but usually do not completely eliminate the biases. If implemented, most of the Administration's recommendations would discourage saving and investment by increasing their exposure to multiple taxation. Despite Administration claims to the contrary, some of its proposals would also aggravate the tax system's already excessive complexity.

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