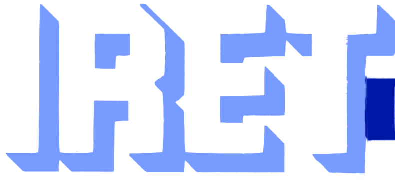

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TAX INCREASES BY ANY OTHER NAME

Along with the much publicized tax reductions in its budget plan, the Administration is including a long list of proposed tax increases. Although the President did not mention the tax increases even once in his State of the Union speech, they are not puny — $76 billion from 1998 through 2002. Some would extend expiring or expired tax provisions; many, the Administration declares, would close supposed corporate tax loopholes or correct other abuses. Most are directed at investment income and generally would be collected at the business level. By and large, these proposals were made by the Administration last year but rejected by Congress then.[1]

One Clinton Administration source is quoted as claiming the tax increases targeted at supposed loopholes would actually "help the economy."[2] According to the source, the proposals, if enacted, would "reallocate resources from tax-avoidance activities to business activity."[3]

In economic analysis, higher taxes on investment income weaken investment by undercutting investment incentives; people are not as eager to invest when higher taxes reduce their after-tax returns. The Administration claims its recommended tax hikes are different. Supposedly, the revenue raisers would ferret out what a senior Administration official describes as "corporate [tax] loopholes and unwarranted [tax] subsidies."[4] In the budget documents it has submitted, the Administration says of its proposals, "The budget eliminates or shrinks a wide range of tax loopholes and preferences that are no longer warranted... Restricting them would help balance the budget,

[1] See Michael Schuyler, "False Charges of Corporate Welfare Fuel Administration Tax Hike Proposals," *IRET Policy Bulletin* No. 66, June 1996 and Michael Schuyler, "The Clinton Economic Plan: Contingent Promises and Hidden Burdens," **IRET** Policy Bulletin No. 69, October 1996.

[2] Clay Chandler, "Corporate Tax Plan Readied," *The Washington Post*, January 31, 1997, p. A8.

[3] *Ibid.*

[4] *Ibid.*

Institute for Research on the Economics of Taxation

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increase the equity and efficiency of the tax system, and keep corporations focused on productivity and profits..."[5]

Passing off higher taxes as a fight against corporate welfare has obvious political appeal, but the Administration's assertions omit an essential step. In order to determine whether a provision in existing law is a subsidy, it must be compared to a neutral tax — one that does not favor or penalize the taxed activity relative to other activities. Such comparisons reveal strong biases in the existing income tax system against saving and investment. Some provisions in current law ease — but generally do not eliminate — those biases. Such provisions are often mistakenly labeled as tax subsidies even though they continue to penalize saving and investment relative to neutral tax treatment. Unfortunately, the Administration does not use tax neutrality as its benchmark.

Many of the [Administration's suggested] provisions would add additional layers of tax on targeted forms of income. Almost all of the recommendations would increase effective marginal income tax rates, especially on income associated with saving and investing.

Running through the proposals are arbitrary, often inconsistent changes in the classification of assets and the timing of events for tax purposes. For example, one proposal would recategorize very long-term debt as equity, while, simultaneously, several proposals argue that the notion of debt should be enlarged to include certain forms of equity. The proposals for recategorizing certain equity as debt would not, however, allow the normal deduction for interest costs on the supposed debt equivalents. The only discernable consistency in the Administration's reclassification proposals is that they would all increase the government's tax take.

Many of the provisions would add additional layers of tax on targeted forms of income. Almost all of the recommendations would increase effective marginal income tax rates, especially on income associated with saving and investing. Most of the provisions would raise the service price of capital (the pre-tax return required on the marginal unit of capital to justify its purchase), meaning that more worthwhile investment projects would be rejected for tax reasons. The Administration's proposals are complex, which would make the tax system more complicated and push up taxpayers' compliance costs. The tax hikes would also be hidden, causing people to underestimate how much they are paying in taxes for government services.

A Representative Sample of the Administration's Proposed Tax Hikes

In its budget submission to Congress, the Administration seeks approximately 50 tax increases or extensions of taxes that are scheduled to expire. Because of the number of proposals and their

[5] U.S. Office of Management and Budget, *Budget Of The United States Government, Fiscal Year 1998* (Washington, DC: Government Printing Office, 1997), p. 115.

complexity, it would not be practical to examine all of them here. A representative sample, consisting of a dozen of the Administration's revenue raisers, is analyzed below.

Require sellers of capital assets to use an average-cost method in computing their capital gains
Notwithstanding Administration rhetoric about corporate taxes, the primary target of this proposal is the individual taxpayer. Under current law, when an investor sells part of his or her holding of a particular security, shares of which were acquired at different times and at differing prices, the investor must specify which shares have been sold and identify their cost or other basis. The investor may rely on various ways to do so. One way is to specify a specific block of shares as the ones sold and use the actual cost of those shares in computing the capital gain (capital gain = sale price - cost). Another way is to assume the first shares bought were the first ones sold and use their cost. Yet another way (permitted with mutual fund shares) is to assume the shares sold were a blend of all the shares owned before the sale and use the average cost of all the pre-sale shares. (If 500 shares were owned before the sale and 100 are sold, the cost of each of the 100 shares is assumed to be the average per-share cost of the 500 shares.) The Administration's proposal would disallow all but the last method, known as the average cost method. Inconsistently, the Administration's proposal would not allow taxpayers to do any averaging in determining holding periods but would require them to use the first-in, first-out method for that purpose. Heads the government wins; tails the taxpayer loses.

To defend its proposal, the Administration says, "[S]pecific identification is artificial and complex."[6] This argues that the Administration's proposal should be accepted in order to simplify the tax code; it does not imply, even if the claim were true, that other identification methods are loopholes. Unfortunately, the Administration's promised simplicity is illusionary. The cost averaging may itself be artificial and complex, often more so than other identification methods, involving as it does a consideration of all shares owned and an artificial blending of their various purchase prices. The complexity is increased because the Administration would force taxpayers to use a different identification method (first-in, first-out) in determining holding periods. The Administration also complains that current law "permits taxpayers to engage in [tax] planning so that the amount of gain or loss they recognize for tax purposes is unrelated to their actual economic gain or loss."[7]. The Administration is correct that current law does allow taxpayers more options than the Administration would. But the mere presence of options does not constitute a loophole unless some of the options are unwarranted, a case the Administration has not succeeded in making. It is hardly a tax subsidy to allow investors to choose among several reasonable basis determination methods.

By restricting investors' options in identifying the cost basis of the shares they sold, this change would effectively raise the marginal rate of tax on investors' capital gains. Suppose, for example, that a person had bought 100 shares of a stock for $8 each in 1980, another 100 shares for $25 each

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[6] "Treasury Department General Explanations Of Clinton Administration's Fiscal Year 1998 Revenue Proposals," issued February 6, 1997, reprinted in *Daily Tax Report*, February 7, 1997., p. L-15.

[7] *Ibid.*, p. L-15.

in 1990, and another 100 shares for $60 each in 1996. (The price of this hypothetical stock increases at roughly the same rate as the Dow Jones stock-market index.) Suppose, further, that the person decides to sell 50 of those shares for $70 each in 1997. If the person uses the specific identification method and identifies the shares as ones that were bought in 1996, the cost basis on each of those shares is $60 and the capital gain on each is $10. If the law were changed along the lines of the Administration's basis averaging proposal, however, the per share cost basis would become $31 (purchases of $800, $2,500, and $6,000 averaged over 300 shares) and the capital gain on each share sold would jump to $39. In this case, the Administration's proposal would increase the capital gains tax by 290%. If the person pays capital gains tax at a 28% rate, his or her tax bill would shoot up from $140 (28% of 50 shares x $10 capital gain per share) to $546 (28% of 50 shares x $39 capital gain per share). Notice that although the statutory tax rate remains 28%, the change in the tax base produces, in effect, a dramatic rise in the person's marginal tax rate.[8]

By restricting investors' options in identifying the cost basis of the shares they sold, this change would effectively raise the marginal rate of tax on investors' capital gains.

The capital gains tax is one of the levies that worsens the tax system's bias against saving and investment. Consider some of the tax penalties. The income tax begins with a fundamental bias against saving and investment. If a person directs some of his or her earnings into saving, the person must pay income tax on both the earnings and the returns on the saving. If the person uses the earnings for current consumption, however, the person pays income tax only on the earnings. By taxing the saving stream twice but earnings used for consumption only once, the income tax places a tax penalty on saving and investment. If individuals invest via corporate equity, the income tax penalty increases because the same income is taxed at the corporate level by the corporate income tax and, if the already taxed earnings are paid out to shareholders as dividends, taxed again at the personal level by the individual income tax. Or, if the after-tax earnings are retained by the company and reinvested, they will increase the company's expected future earnings, which will increase the company's stock price. When the retained earnings generate income in the future, that income will itself be subject to tax. Individual shareholders can realize the retained earnings by selling their shares, but at that point they must pay capital gains tax, effectively paying tax on the retained earnings again. In summary, rather than taxing the income stream once, the current tax system applies layer after layer of income tax. One of those excess layers of income tax is the capital gains tax. In order to move towards tax neutrality, the capital gains tax should be reduced or, better, eliminated.

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[8] To be sure, if the person subsequently sells the remaining 250 shares, the capital gain reported on them for tax purposes would be correspondingly lower. The effect of the Administration's proposal in that case would be to front-load the capital gains tax. Because time has value, forcing taxpayers to pay taxes sooner is equivalent to a higher marginal tax rate.

By increasing the marginal capital gains tax rate, the Administration's proposal would push up the tax-inclusive service price of capital. The higher is the service price of capital, the smaller is the amount of additional capital that will be undertaken. With less capital, workers would be less productive than otherwise. Since their real wage rates closely approximate their marginal productivity, the proposed increase in the tax on capital gains would largely be at the expense of workers' gains in employment and real wage rates.[9]

In addition to the economic damage it would cause, a stiffer capital gains tax would not even be very effective as a revenue raiser. The higher marginal tax when assets are sold would cause investors to sell assets less frequently (the lock-in effect), depress asset prices (reducing the stock of unrealized gains), and weaken the economy (reducing tax revenues from other sources). These feedback effects would whittle away at the potential revenue gain. Some studies suggest a heavier capital gains tax may be a revenue loser.

Prohibit issuers of corporate bonds with maturities exceeding 40 years from deducting their interest payments When businesses issue debt, they can normally recognize interest payments on the debt as business expenses and deduct those costs in computing taxable income. The Clinton Administration wants to deny the deduction of interest paid on corporate securities with maturities of over 40 years. This would most affect 100-year bonds, which were once common, then fell into disfavor when inflation was higher and more volatile, but are now being issued by a few companies. The Administration's position is that when the maturity of a debt instrument extends past a certain point, the debt instrument becomes like equity. The Administration notes that dividends on equity are not deductible and asserts that the same disallowance should apply to supposedly equity-like debt; doing otherwise, it hints, is a tax loophole. "The line between debt and equity is uncertain, and it has proven difficult to formulate general rules to classify an instrument as debt or equity for all purposes....Taxpayers have exploited this lack of guidance by, among other things, claiming interest deductions for instruments that have substantial equity features..."[10] This is one of a number of proposals that, according to the Administration, "clarifies the treatment of new financial instruments that aim to exploit the different tax treatment of equity and debt, by denying or deferring interest deductions on certain instruments that have substantial equity features."[11]

The Administration's proposal, however, completely ignores the legal and economic distinctions between debt and equity. Those distinctions do not depend on the maturity of the instrument. If the debt-vs-equity character of a financial instrument depended on its maturity, for instance, commercial paper and 3-month Treasury bills would be virtually pure debt, but 30-year corporate and Treasury bonds would be regarded almost as stocks. In fact, there is no such relationship. A basic distinction between debt and equity is that debt holders have greater certainty than equity owners regarding

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[9] The benefits to workers of increases in capital formation are extremely significant. Many studies have found that about one-third of the gain in output goes to capital owners and about two-thirds goes to labor.

[10] *Treasury Explanations, op. cit.*, p. L-13.

[11] *U.S. Budget FY98, op. cit.*, p. 115.

future payments because the payment schedule on debt securities is generally specified in advance. Further, debt holders enjoy legal priority over equity owners in receiving payments: debt holders can push a company into bankruptcy if they are not paid; equity owners cannot. On the other hand, if a company prospers, equity owners have greater potential to share in the gains. These distinctions are unrelated to a debt's maturity; they are the same whether a debt's term is 3 months or 100 years. Even the Administration seems uncomfortable with its argument, for it admits that the bonds whose interest costs would become nondeductible are not really equity: "The proposal is not intended to affect the tax characterization of instruments described in this proposal as debt or equity under current law."[12]

The Administration's position is that when the maturity of a debt instrument extends past a certain point, the debt instrument becomes like equity...The Administration's proposal, however, completely ignores the legal and economic distinctions between debt and equity. Those distinctions do not depend on the maturity of the instrument.

In assessing the Administration's proposal, it should also be understood that the deduction for interest costs is not a tax loophole. Income should be measured net of legitimate business expenses, and interest is one of those expenses. Clearly, if the interest were not deductible, the before-tax interest that a borrowing company would be willing to pay per dollar of borrowing would be less than under present law. The consequence would be that lenders would be willing to invest less in the company or would require other, greater rewards for doing so. The cost to the company of attracting the saving it requires to finance its capital additions would be raised by the Administration's proposed arbitrary change in the tax treatment of long-term debt.

Beyond this, however, the Treasury proposal would result in double taxation. If debt service payments could not be deducted, they would be included in the tax bases of both the businesses paying the interest and the lenders receiving the interest. Thus, two different parties would be paying income tax on the same income.

On the payments it affected, this change would generate an enormous rise in marginal tax rates, and, in turn, in the service price of capital. Suppose a company intends to finance a marginal dollar of investment with a 100-year bond issued at 10% interest. Assume that the company's marginal tax rate is 35%. Suppose, also, that under current law the company faces a service price of capital of 15%: the marginal dollar of investment must generate a gross return of 15% to provide the company with an adequate reward on its managerial efforts after subtracting interest, taxes, and other expenses and adjusting for inflation. If the interest payments become nondeductible as proposed by the Administration, the change would suddenly increase the company's tax bill. As a result, a 15% gross

[12] *Treasury Explanations, op. cit.*, p. L-13.

return, which previously sufficed, would no longer provide the company with an adequate after-tax return. To counterbalance the higher tax, the company's service price of capital would have to rise to 20.38%, a jump of 35.9% (5.38 percentage points).[13] This sharp rise in the service price of capital would squeeze out many desirable investments.

How does the Administration's selective tax penalty on a particular form of debt improve the allocation of anything? If companies planning to issue 100-year bonds to finance their investment projects did not have other financial options, many would cancel the investments because of the extraordinary increase in the tax-inclusive costs of the investments. The loss of valuable investment projects would lead to a weaker economy, characterized by lower productivity, less output, and lower incomes for capital owners and labor. In many cases, companies could avoid the new tax by financing their investments with bonds whose maturities did not exceed 40 years or by issuing stock. If they all do this, the tax will raise no revenue at all. Still, when companies find they must rearrange the financing of their investments because of a new tax, some may have second thoughts about making the investment, causing a decline in the total quantity of investment.

This proposal may also be of concern because of the precedent it would set for limiting the tax deduction on interest payments. Given the tendency in Washington to argue that a restriction on taxpayers in one case ought to be extended to taxpayers in other cases, one must wonder whether this or a subsequent Administration would later assert that if interest on 100-year bonds is nondeductible, interest on, say, 30-year bonds should also be nondeductible. After all, since the Administration is being entirely arbitrary when it claims that debt becomes like equity after 40 years, it could later try to move that arbitrary line.

<u>Accelerate assessment of capital gains tax when asset owners largely eliminate risk through hedges</u>
Under current law, the owner of an asset is generally not charged capital gains tax on the asset until gain or loss on the asset is realized, that is, until the asset is sold, exchanged, or otherwise disposed of. The Administration would change this by assessing the tax earlier if the asset has risen in value and if the taxpayer (or sometimes a relative of the taxpayer) "substantially eliminates [further] risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property."[14] The Administration calls the elimination of risk a "constructive" sale and says that a "constructive" sale should be treated as a regular sale, provided the asset's value has risen. If a "constructive" sale produces a capital loss, though, the Administration would not view it as the equivalent of a regular sale.

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[13] With interest deductible, the after-tax cost of the debt financing was 6.5%: 10% interest payment minus 3.5% tax reduction due to reduced income. With interest non-deductible, the after-tax cost of the debt financing would rise to 10%. To make up for the higher tax, the company would need an extra 5.38% of gross return. (The increase in the gross return exceeds 3.5% because it is itself subject to tax. Given the company's tax rate, it is 3.5% on an after-tax basis.)

[14] *Treasury Explanations, op. cit.*, p. L-16.

Most press stories and Administration comments have described this proposal in terms of a procedure known as "selling short against the box", but the proposal is potentially much broader; it applies to using hedges that eliminate most of the risk from price fluctuations in an asset, not to a particular procedure for doing so.

Because the important economic functions of hedges are often misunderstood, it is useful to begin by describing them. Generally, a tradeoff exists between the riskiness of an asset and the asset's expected return. For instance, a 3-month Treasury bill has low risk and a low return while a growth stock is much riskier but has a far higher expected return. The willingness to shoulder risk in order to seek higher expected returns varies from investor to investor. Furthermore, it often varies for an individual investor over time as the investor's specific circumstances change. Hedges provide a means for investors to adjust the riskiness vs. expected returns on their assets better to meet their preferences. Suppose one investor would like to reduce risk on an asset and is willing to sacrifice some potential return to do so. Suppose another investor attaches more priority to the possible return and is willing to bear added risk. Then both parties can better satisfy their wants by entering into a transaction in which the first party shifts some of the asset's risk to the second in return for the second being able to claim more of the asset's future returns. Under this arrangement, the total returns on the asset remain taxable to one or another of the two parties. The earnings may be shifted from one taxpayer to the other, but they do not escape tax, as can be seen if both parties to the transaction are included in the analysis.

Often hedges are criticized because only the party taking on risk is considered. In that incomplete analysis, hedges are then disparaged as being akin to gambling. As just explained, however, the typical hedge has two parties — one reduces risk and the other accepts risk — and the hedge serves the very valuable economic function of allowing investors to come closer to their risk-return preferences. In the past, it has sometimes been suggested that the government ought to use taxes or regulations to restrain the party taking on risk to obtain a higher expected return. Ironically, the Administration's proposal attacks the other side, in seeking to toughen the tax treatment of the party anxious to reduce risk.

Another motivation for hedging is that two parties may have different expectations about an asset's future returns. One may be fearful the asset's price has a good chance of falling; the other may think its price is likely to rise. Because of their divergent expectations, a hedge makes good sense for both of them (with the two parties on opposite sides, of course.)

These two motivations do not depend on tax considerations. Even if taxes did not exist, people would often want to hedge because doing so allows them to tailor their investments to their risk-return preferences and their expectations about the future. Further, if new tax rules penalized hedges, investment would suffer because potential investors would confront heavier tax-inclusive costs when they tried to adjust the mixture of risk and expected return they carried. Those higher costs would make people more reluctant to invest in the first place.

The Administration totally ignores these reasons for hedging and pretends that hedges are necessarily wasteful and undesirable. "If you didn't save a dime [that is, collect any taxes sooner], I think this [Administration proposal] is something you should do," said Treasury Secretary Rubin at a Congressional hearing. "When you allow these kinds of distortionary mechanisms to exist, they absorb a lot of capital that would otherwise be put to productive use."[15] In reality, as explained above, hedges, which Secretary Rubin dismisses as "distortionary mechanisms", are extremely important and valuable to investors for nontax reasons. When investors wish to reduce their exposure to risk, hedges are an efficient means to do so that require a minimum amount of capital to achieve the purpose. Absent hedges, it would become more difficult and expensive for investors to lay off risk. Making hedges into tax targets would make investment less desirable, and that would reduce the amount of investment. Thus, instead of absorbing "a lot of capital", hedges help people manage their investments, which leads to more capital formation than otherwise.

Even if taxes did not exist, people would often want to hedge because doing so allows them to tailor their investments to their risk-return preferences and their expectations about the future...[I]f new tax rules penalized hedges, investment would suffer because potential investors would confront heavier tax-inclusive costs when they tried to adjust the mixture of risk and expected return they carried.

There is a third reason for using hedges that is tax related. If a person wants to sells an asset and does so in the current year, that is treated as a taxable realization that year. If a person uses a hedge in the current year to lock in the asset's current price but does not sell the asset until the next year, that is generally treated as a taxable realization in the next year. Thus, a person who wants to sell an asset at its current price can use a hedge so that the taxable realization occurs in the next tax year. This motivation is often a factor in the type of hedge known as selling short against the box. In selling short against the box, an investor arranges to sell borrowed shares while owning identical shares. For example, an individual who owns 100 shares of XYZ Company might borrow 100 shares of XYZ Company and sell the borrowed shares. Because the person now has opposing positions in the owned and borrowed shares, the person will neither gain nor lose from subsequent changes in the price of XYZ stock. Under current law, a taxable realization is not deemed to occur until the positions are closed (perhaps by using the owned shares to replace the borrowed shares), and the closing of positions might not happen until the next tax year. But delaying receipt of the proceeds from a sale is not costless. The revenue received next year instead of this year is of less value to the seller, and his tax liability should be lower — or postponed until next year — to reflect this.

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[15] Reported in *Daily Tax Report*, February 13, 1997, p. G-3.

Whether or not a short-against-the-box position is taken solely for tax reasons, though, the effect of the Administration's proposal on an investor selling short against the box should be considered. If the procedure produces a gain, the taxable realization would be deemed to occur immediately under the Administration's proposal, which in many instances would speed up the investor's tax liability by a year. Because time has value, that, in effect, raises the tax rate on the gain from the investment. At a 10% discount rate, for instance, the change would effectively boost the marginal tax rate on capital gains by 10%. The higher capital gains tax would reduce the incentive to invest; that would tend to lower the quantity of investment; and the tax-induced drop in investment would hurt the economy. Thus, even in those instances where selling short against the box is tax motivated, the Administration's recommended change in the law would have negative economic consequences that should be weighed against the efficiency gains the Administration promises. Note, too, that the tax on the capital gain is a form of double taxation to begin with.

Although the Administration insists that current law, which does not regard substantial risk reduction through hedging as equalling asset disposition, is wrong, the details of the Administration's proposal indicate either that the Administration is not really sure or that the Administration is simply casting about for ways to hike taxes. If the Administration is sincere in its stated belief that eliminating risk from subsequent changes in an asset's price is a "constructive sale", the proposed rule should apply whether a "constructive sale" produces a capital gain or a capital loss. The Administration, however, would only apply its new rule when doing so would produce a capital gain. When a taxpayer has an asset that has declined in value and uses a hedge to protect against further price movements, the Administration would not recognize a realization. Again, heads the Treasury wins; tails the taxpayer loses. Like the Administration's basis-averaging proposal, this one would place further restrictions on taxpayers' choices in figuring capital gains in a way that would accelerate the investors' tax liabilities.

Another concern is tax complexity. The Administration says a hedge that "substantially eliminates [further] risk of loss and opportunity for gain" on an appreciated position should be treated as a taxable realization. How much risk reduction would trigger the tax — and how much leeway would the IRS have in interpreting the amount of risk reduction? While it may be clear enough when selling short against the box, there are many other risk-reduction techniques and situations for which it is very unclear. The Administration's proposal, if enacted, virtually guarantees legal uncertainty and costly disputes between taxpayers and the IRS. Taxpayers trying to reduce risk would have to be wary of falling into tax traps that accelerate their tax liabilities. Good tax policy should strive to reduce tax uncertainty and administrative costs, not increase them.

If the Administration's proposal is adopted in any form, the situations to which it applies should be clearly and explicitly spelled out in the law. For example, if it applies only to selling short against the box, there would be much less uncertainty and potential for confusion than under the Administration's current proposal.

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.

Since the Administration nowhere contends that the current carryback period is so long as to afford a subsidy for loss companies, it is surely deceptive to include it among alleged subsidies and loopholes...This proposal is a tax rate hike in disguise...Especially disadvantaged would be the risky investments that often add great vigor to an economy: start-up businesses and investments based on innovative technologies.

The Administration, however, wants to shorten the carryback period to just 1 year and claims it is merely trying to simplify the tax code. In the Administration's words, "[B]ecause of the increased complexity and administrative burden associated with carry-backs, the period of carry-back should be shortened."[16] Perhaps to give the appearance of being evenhanded, the Administration would lengthen the carryforward period to 20 years. The Administration, which expresses such concern about the complexity of the carryback period, posits that the carryforward period can be lengthened "without substantially increasing either complexity or administrative burdens."[17]

Carrybacks are more helpful to companies with losses than carryforwards because carrybacks reduce taxes immediately while carryforwards only reduce future tax payments.[18] 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 example, if a $1 NOL in the current year can be claimed as a carryback to a year in which income was realized, tax on $1 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

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[16] *Treasury Explanations, op. cit.*, p. L-18 to L-19.

[17] *Ibid.*, p. L-19.

[18] 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.

be carried forward, say, 15 years and the discount rate is, say, 10 percent, the discounted value of the $1 NOL plummets to 24 cents.

Since the Administration nowhere contends that the current carryback period is so long as to afford a subsidy for loss companies, 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.

This proposal is a tax rate hike in disguise. Anyone planning a capital outlay must take account of possible losses as well as gains. If the Administration makes the tax consequences of losses more onerous (i.e., increases the asymmetry in tax treatment between gains and losses), that is the same as reducing the weighted mean of the likely net return. Hence, this change in the tax code would increase the service price of capital, causing fewer investment projects to be undertaken. Especially disadvantaged would be the risky investments that often add great vigor to an economy: start-up businesses and investments based on innovative technologies.

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.)

This proposal to shorten the carryback period while lengthening the carryforward period is anything but evenhanded. It is punitive. 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>Scale back the dividends received deduction (DRD)</u> Under current law when a corporation receives a dividend from another corporation, it may exclude part of the dividend from its taxable income. The exclusion is 100% if the recipient owns at least 80% of the stock of the dividend payor, drops to 80% if the recipient owns between 20% and 80% of the dividend payor's stock, and falls to 70% if the recipient's ownership stake is less than 20%. The Administration recommends that the 70% deduction be cut to 50%. In addition, the Administration would prevent companies from claiming a DRD unless they met a more restrictive holding-period requirement than that specified under current law. Furthermore, the Administration wants to scrap the DRD altogether on limited-term preferred stock.

If there were no deduction for inter-corporate dividends, the cumulative tax at the corporate level would rise far above its statutory rate of 35% because a succession of companies would each be paying tax on the same income. For instance, suppose Company A earns $100 and, after paying $35 of corporate tax, remits the remaining $65 to Company B. If there were no inter-corporate deduction, Company B would have to pay $22.75 on the dividend, leaving it with only $42.25 of the

original $100. The cumulative corporate-level tax would be 57.75%.[19] To prevent the cumulative corporate tax from exceeding the 35% statutory rate, the dividend received deduction needs to be 100%. Thus, in most cases the current-law DRD is already too small to be adequate. The Administration's proposals would worsen the multiple taxation at the corporate level.

If there were no deduction for inter-corporate dividends, the cumulative tax at the corporate level would rise far above its statutory rate of 35% because a succession of companies would each be paying tax on the same income...[T]he current-law DRD is already too small to be adequate. The Administration's proposals would worsen the multiple taxation at the corporate level.

Its effort to cut the 70% exclusion to 50% would do so in the very category (ownership stake less than 20%) where the DRD is already most deficient. Consider the previous example of Company A earning $100 and paying the $65 that remains after tax to Company B. With the present 70% DRD, Company B's corporate tax is $6.825 (35% tax on 30% of $65), leaving B with $58.175 of the original $100 and making the cumulative corporate income tax 41.825%. Under the Administration's plan, B's tax would rise to $11.375 (35% tax on 50% of $65), leaving B with only $53.625 and pushing the cumulative corporate income tax to 46.375%. That is a 4.55 percentage point increase in the marginal tax rate at the corporate level on the investment return.

In arguing for its request, the Administration seeks to make the DRD conditional on whether corporations are "alter egos" of each other. "The 70-percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest..."[20] The Administration seems to be saying that dividends between companies should always be taxed unless they are financial flows within what is, in effect, the same company. On its own terms, this rationale is deficient because it does not explain why current law's 70% DRD is suddenly "too generous" while 50% is just right. Actually, if the Administration's argument were accepted, it could be used to argue that the DRD ought to be abolished unless one company is wholly owned and controlled by another. (Perhaps the Administration's request this year is an interim step toward that end.)

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[19] That is not the end of the income taxation. If Company B passes the $42.25 to its individual shareholders as dividends, they must pay individual income tax on it. If Company B retains the $42.25, it will increase the value of B's shares and this gain will be taxed as a capital gain at the individual level when individual owners sell their shares. For an individual in, say, the 28% tax bracket, the individual level tax is $11.83, leaving only $30.42 of the original $100. That is a cumulative corporate-individual income tax rate of 69.58%. By contrast, if Company A were owned by individual shareholders and it paid a $65 dividend directly to them, the shareholders would pay $18.20 in tax, leaving $46.80 of the original $100. The combined tax would be "only" 53.2%.

[20] *Treasury Explanations, op. cit.*, p. L-14.

More important, the Administration's rationale completely fails to address the extraordinarily high total corporate tax that results when one corporation pays dividends to another. Incredibly, the Administration actually portrays the DRD's partial relief from multiple taxation at the corporate level as creating "tax arbitrage opportunities that undermine the separate corporate income tax."[21] The Administration's assumption is that it is tax arbitrage if, when one company pays a dividend to another, both do not pay corporate income tax on the same income; in other words, anything less than multiple taxation is tax arbitrage, according to the Administration. Multiple taxation of the same income, however, is not good tax policy. Again, to prevent the cumulative corporate tax from exceeding its statutory rate of 35%, the DRD needs to be raised to 100%, not lowered. The Administration also fails to consider that companies ought to be viewed as mere custodians of the income of their ultimate owners, the shareholders. There ought not be any tax on dividends or retained earnings at the business level, only at the shareholder level. And this is true regardless of the number of companies through which the income must pass before it reaches the shareholders.

Moreover, the Administration's proposal would have the effect of increasing the tax penalty on a company that buys part, not all, of another company. Is there a tax principle against partial as opposed to complete ownership? If there is, the Administration certainly has not explained it. Accepted economic theory provides no basis for imposing tax restrictions of this sort on the portfolio decisions of businesses. The government should not be telling businesses how to structure themselves.

The Administration's argument for stiffening the holding period requirement is, "No deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest..."[22] The Administration goes on to say that when its suggested holding-period requirement is not met, stock becomes "the equivalent of a bond", implying that dividends are the equivalent of bond interest. One flaw in this argument is that it is irrelevant. The key problem is that when one corporation pays a dividend to another, the same income will be taxed twice at the corporate level unless there is a 100% DRD. Regardless of whether the inter-corporate transfer is classified as dividend or interest, the income should not be taxed twice (in addition to the third tax at the shareholder level).

A second problem is that neither economics nor finance supports the notion that equity transmutes into debt if an arbitrarily specified holding period is not met. Even on its own terms the Administration's argument is inconsistent in a heads-the-government wins, tails-the-taxpayer-loses manner. If the Administration honestly believes that dividends become interest unless its proposed holding-period requirement is met, the company paying the dividend should be able to treat it as stock. If both the payor and the payee treat the dividend like debt, the payor would deduct it and the payee would include it in income. Thus, it would be taxed once at the corporate level. Rather than

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[21] *Ibid.*, p. L-14.

[22] *Ibid.*, p. L-14.

being consistent, however, the Administration would exact a double tax by forcing the payor to treat the dividend like equity and the payee to treat it like interest, thereby denying deductions to both.[23]

The Administration's proposals for reducing the DRD would harm saving and investment by adding to the tax penalties on the corporate form of business organization. Indeed, even if the DRD were raised to 100%, corporate earnings would still be double taxed, once at the corporate level by the corporate income tax and a second time when realized at the individual level by the individual income tax. Scaling back the DRD would worsen the multiple taxation. The heavier tax would also intensify an unwarranted tax signal to corporations either not to own shares in each other or to increase their holdings towards complete ownership.

Treat certain preferred stock as "boot", which would cause more corporate reorganizations to trigger immediate taxes on shareholders 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). 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..."[24]

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 states, "[M]any preferred stocks are functionally equivalent to debt securities."[25]), businesses could deduct their preferred stock

[23] In its long-term bond proposal, the Clinton Administration is trying to raise taxes by claiming debt is like equity. Here it is trying to raise taxes by claiming equity is like debt. The Administration seems to be arguing whichever way would raise taxes in any given case!

[24] *Treasury Explanations, op. cit.*, p. L-19.

[25] *Ibid.*, p. L-19.

dividends. Of course, the Administration proposes nothing of the sort; the reclassification it wants favors the tax collector. In this case, it would call equity debt.[26]

The Administration would not be closing a tax loophole here but taking advantage of taxpayers. For the taxpayers it affected, this proposal would sharply increase the marginal tax rate on their investments and impair the market's ability to signal desirable, efficiency-enhancing changes in business organization. Because the tax would be triggered by certain corporate reorganizations, it would tend to lock in existing business arrangements, making change more difficult and existing organizational structures more rigid. Spinoffs and other corporate reorganizations are important to the economy because they help businesses operate more efficiently. If the government succeeds in erecting 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 S corporations must meet various requirements, such as having no more than 35 shareholders (recently raised to 75). These conditions bar many companies from becoming S corporations. Under tax code section 1374, if a C corporation satisfies the requirements and elects to convert into an S corporation, it can do so without triggering taxes. (If the S corporation sells within 10 years assets that it held at the time of the conversion, though, it must pay tax on the assets' built-in gain.) The Administration wants 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 appreciated assets within the corporation. At the shareholder level, capital gains tax would be due on any appreciated value in the shares of the company.

When businesses are organized as sole proprietorships or partnerships, business earnings are imputed directly to the individual owners and taxed at the individual level. S corporations, which resemble partnerships in having a relatively small number of owners, receive similar tax treatment: incomes from S corporations 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. When businesses are organized as C corporations, however, the government applies a tax penalty: earnings from the business are taxed at the corporate level and again at the individual level. The Administration refers to this difference in tax treatment of business income when it says, "C corporations are generally subject to a two-tier tax [i.e., two income taxes on the same income]. A corporation can avoid this two-tier tax by electing to be treated as an S corporation..."[27]

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[26] If the Administration's argument were accepted and followed to its logical conclusion, it would suggest that all outstanding preferred stock should be rated in terms of likelihood of recovery of principal and maintenance of dividends, and treated partially as stock and partially as debt based on the rating, with the debt share treated as debt throughout the tax code (implying deductibility of a portion of preferred stock dividends).

[27] *Treasury Explanations, op. cit.*, L-19.

Substituting a single level of tax for two levels of tax, though, is hardly a tax break. Instead, it is a move towards more principled, less onerous taxation. From the perspective of good tax principles, income from a business should not be subject to two separate income taxes on the same income. The single-level tax on sole proprietorship earnings, partnership earnings, and S corporation earnings could serve as a model for how C corporation earnings ought to be treated.[28]

Substituting a single level of tax for two levels of tax...is hardly a tax break...From the perspective of good tax principles, income from a business should not be subject to two separate income taxes...The Administration's idea [to tax conversions of C corporations to S corporations] does not address a tax loophole but would accentuate overtaxation.

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."[29] 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. Third, capital gains taxes are doubly inappropriate in this case. When the earning power of a business increases, that tends to be reflected in a higher share price. Thus, taxing asset appreciation at the business level and share appreciation at the shareholder level subjects the same appreciation to two 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.

Instead of leveling the playing field by eliminating double taxation, the Administration's proposal would add to the multiple layers of tax on income genrated by corporations. The Administration's idea does not address a tax loophole but would accentuate overtaxation.

Impose a corporate-level capital gains tax on certain business spinoffs Suppose that one company would like to acquire the assets of a second company but that some parts of the second company would not be a good fit in the post-acquisition organization. Using a legal arrangement known as

[28] Once upon a time, it would have been computationally difficult to take the income of a large corporation and figure out how much to attribute to each shareholder. That computational challenge may help explain, historically, why there is a separate income tax on C corporations rather than imputing the income directly to owners, as is done with sole proprietorships, partnerships, and S corporations. Today, however, the computational constraint no longer exits. Modern computers can perform the required calculations easily.

[29] *Treasury Explanations, op. cit.*, L-19.

a Morris Trust, the second company can spin off to its shareholders the unwanted assets prior to the acquisition without triggering capital gains tax. The Administration seeks to impose a test that in many cases would not be met after the acquisition, making the spinoff subject to a corporate-level capital gains tax. According to the test, the spinoff would become taxable if the historic shareholders of the distributing company did not retain at least 50% control of the distributing company and the spinoff in the 2 years preceding and the 2 years following the spinoff. The rub is that with the acquisition the interest of the historic shareholders of the distributing company would often fall below 50%.

Under the Administration's proposal, one capital gains tax would be assessed at the corporate level on the spinoff. In addition to this, as the Administration notes, current law already assesses a capital gains tax on the spinoff at the individual level when individual shareholders sell their stock.

To defend this proposal, the Treasury states, "A corporation is generally required to recognize gain on the distribution of property (including stock of a subsidiary) if such property has been sold for its fair market value."[30] The Treasury then says such a capital gains tax should come due in the case of Morris-trust arrangements, "Corporate nonrecognition under [tax code] section 355 should not apply to distributions that are effectively dispositions of a business."[31]

The proposed limitation on the use of the Morris trust arrangement would impose a new capital gains tax on investments that are already subject to multiple income taxes.

In its argument the Treasury does not inquire whether it is desirable to tax distributions. The tax would be appropriate if income could be invested and earn a return without being subject to any income tax except for this one tax. Not having the tax would then be a genuine loophole. On the other hand, if investments are taxed at other points — which they are — this tax contributes to multiple taxation and penalizes saving and investment. The tax code would be more efficient, simpler, and fairer without this tax. The Treasury also does not ask whether spinning off a subsidiary by issuing stock to shareholders should be regarded as "property ... sold for its fair market value." It is a stretch to call a spinoff a sale at fair market value just because shareholders who had previously owned a subsidiary through their stock in the distributing company now have separate shares for the spun-off subsidiary and the rest of the company.

The proposed limitation on the use of the Morris trust arrangement would impose a new capital gains tax on investments that are already subject to multiple income taxes. It would, accordingly, to no identifiable constructive purpose increase the tax cost of changing corporations' organizational

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[30] *Ibid.*, p. L-20.

[31] *Ibid.*, p. L-20.

structures. Faced with the increased marginal rate of tax on capital that is reallocated via a new corporate structure, some companies would decide to go it alone although joining with other companies would be more efficient. With some acquisitions that did proceed, companies would decide to retain units that they thought could become more productive if spun off because retaining the unwanted units would avoid the new tax.

Deny non-financial corporations deductions for a portion of their interest expenses based on their holdings of municipal bonds Under current law, interest costs on debts incurred to finance the purchase of tax-exempt securities generally cannot be deducted. Financial institutions face a tougher restriction. They are required to apply an interest allocation rule, according to which it is arbitrarily assumed that they used a portion of their debts to finance the purchase of any tax-exempt municipal securities they own. For those institutions, "debt generally is treated as financing all of the taxpayer's assets proportionately."[32] The Administration wants to extend this allocation rule to non-financial corporations (except insurance companies). The percentage of a company's debt charges allocated to tax-exempt munis by the proposal, and rendered nondeductible, would equal the percentage "of their [the company's] total assets that is comprised of tax-exempt investments."[33]

Notice that current law already bars taxpayers from deducting interest on debt used to finance muni purchases. Thus, the effect of the proposed rule would be to disallow deduction of interest charges on debt that did not finance munis. This slants tax calculations in a way that favors the government at the expense of taxpayers and can be expected to damage the market for municipal obligations. For example, if a company is paying interest on bonds that it issued several years ago to finance a new factory and if it now buys some munis, the Administration's proposal would render nondeductible a portion of the debt service costs on the bonds that helped finance the investment in the factory. The Administration brushes such problems aside by assuming that "borrowing for one purpose frees money for other purposes."[34] In this case, the Administration would regard the previous debt taken on to finance the factory as equivalent to borrowing now to buy the munis, notwithstanding the facts.

At a more fundamental level, the Treasury is incorrect in its position that interest charges should be nondeductible when taxpayers use the borrowed funds to buy tax-exempt securities. The Treasury worries that allowing the deduction would provide taxpayers with "double Federal tax benefits" (tax-exempt interest income and tax deductible interest costs), enabling them to shrink the tax base at will.[35] What the Treasury overlooks is that for every borrower who pays interest there is a lender who receives interest. That is relevant because interest payments are included in lenders' incomes. For example, if someone borrows from a lender to buy a muni and subsequently pays the

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[32] *Ibid.*, p. L-15.

[33] *Ibid.*, p. L-15.

[34] *Ibid.*, p. L-15.

[35] *Ibid.*, p. L-15.

lender $100 of interest, that $100 is added to the lender's income. Thus, allowing someone who buys munis with borrowed funds to deduct his or her interest payments would not shrink the tax base relative to its size if the borrowing had not occurred: the interest cost subtracted from the borrower's income ($100 in the example) is offset by the interest income added to the lender's income ($100 in the example). If interest payments were not deductible, on the other hand, the tax base would increase when people borrowed because the same interest payments would be included in the taxable incomes of both borrowers and lenders. (The increase would be $100 in the example.)

The Administration's proposal is a poison pill that would impose a stiff penalty on non-financial corporations holding municipal securities...Assuming munis are intended to be tax-exempt, the current rules are already too restrictive. They should be eased, not tightened.

The Administration's proposal is a poison pill that would impose a stiff penalty on non-financial corporations holding municipal securities. Non-financial corporations would respond by selling many of the munis they now hold and thinking long and hard about buying new ones. That would constrict the demand for munis, making it more expensive for state and local governments to finance their debts. Indirectly, then, the Administration's proposal is an attack on the ability of state and local governments to borrow. Given the nation's federal system of government and the importance of tax-exempt munis to state and local governments, that raises serious financial and political issues which the Administration fails to address in its proposal. If the Administration objects to the tax-exempt status of municipal bond interest, it should attack munis directly and take the accompanying political heat. Assuming munis are intended to be tax-exempt, the current rules are already too restrictive. They should be eased, not tightened.[36]

Repeal a rule allowing half of export earnings to be treated as income from foreign sources Under a rule that has been in effect almost as long as the income tax has been in existence, U.S. multinational companies can allocate their income from export sales on a 50-50 basis between production and sales, with the sales classified as generating foreign source income if they occur abroad. The Administration proposes to eliminate this export sales source rule and replace it with an "activity based" allocation procedure that would tend to give more weight to the location of production. If companies were forced to use the activity based rule, many would show decreases in how much of their income they could categorize as foreign source, reducing their ability to claim U.S. tax credits for the income taxes they pay to foreign governments. The Administration estimates this would increase exporting companies' tax bills by about $7.5 billion over 5 years.

[36] The tax exemption that municipal securities provide is often regarded as a tax loophole. It is not. Ordinarily, the income tax overtaxes saving relative to consumption. Suppose, though, a taxpayer has income and is choosing between using the money for consumption or to buy tax-exempt munis. The choice is tax-neutral because in either case the income will be taxed just once: neither the benefits from consumption nor the returns on the muni are subject to further income tax.

The United States allows its taxpayers to claim U.S. tax credits for the income taxes they pay to foreign governments. The United States permits these foreign tax credits (FTCs) because, unlike many other nations, it taxes its business and individual taxpayers on their worldwide incomes. Paying two nations' income taxes on the same income would obviously put U.S. companies trying to do business abroad at a grave competitive disadvantage compared to foreign rivals paying only one income tax. The purpose of FTCs is to avoid this double taxation.

In seeking added revenues over time, however, the U.S. government has increasingly tightened the rules for allocating receipts and costs between domestic and foreign sources, which has cut the income taxpayers can classify as foreign source and reduced the maximum amount of foreign taxes on which they can claim credits. When a U.S. company pays income taxes to a foreign government, the credit that the company can claim against the U.S. income tax cannot exceed the lower of: (a) the company's actual foreign tax payments or (b) the U.S. tax that would be due on the income. For example, if a company has $100 of foreign source income and pays $33 of foreign income taxes, it could claim $33 of FTCs, assuming the U.S. tax on the $100 is $35. But if the United States modifies its allocation rules so that foreign source income for tax purposes falls to $80, the maximum credit would drop to $28, assuming the U.S. tax on $80 would be $28. The firm would then have $5 of excess FTCs it could not claim ($33 foreign taxes - $28 maximum credit) and its U.S. tax liability would rise by $5. The U.S. allocation rules and other restrictions often prevent U.S. taxpayers from fully crediting their foreign tax payments against their U.S. tax liabilities.

The Administration offers two rationales for its proposal. First, it says, "The existing 50/50 rule provides a benefit for U.S. exporters that also operate in high-tax countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States."[37] This argument is complicated and roundabout. The Administration is aware that U.S. companies with operations in other countries often pay more income taxes to foreign governments than the companies can claim as credits against their U.S. taxes. The Administration then claims that when these companies export, the export sales rule allows the companies to allocate too much of the resulting income to foreign sources, which inflates their apparent foreign source incomes. The extra income categorized as foreign source, says the Administration, lifts the ceiling on the quantity of foreign tax credits the companies can claim and enables them to credit against their U.S. taxes more of the foreign taxes assessed on their foreign operations. The Administration is asserting, in other words, that under the export source rule companies with foreign operations gain a tax advantage when they export: they can sometimes claim FTCs stemming from their foreign operations that would otherwise be excess. The Administration insists that it is motivated by a concern that exporters without foreign operations are relatively disadvantaged because they do not gain this alleged benefit when they export.

What the Administration does not point out, however, is that the main reason many companies are concerned about paying more foreign income taxes than they can claim in FTCs is that the U.S.

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[37] *Treasury Explanations, op. cit.*, p. L-24.

allocation rules are already subject to so many restrictions. For instance, foreign source income is divided into categories by country and type of income, with a separate limitation on each type of income in each country. U.S. companies operating abroad often find that the maze of limitations understates their foreign source incomes, arbitrarily denying them U.S. tax credits for some of the foreign income taxes they pay. This handicaps the companies by compelling them to pay two nation's income taxes on the same income. Given that severe U.S. limitations are the main reason why U.S. taxpayers often have FTCs they cannot claim, it is ironic that the Administration would cite the problem of excess FTCs in arguing for yet another limitation. Under the guise of treating all exporters equally, the proposal would throw a greater double-tax roadblock in the path of many U.S. firms trying to maintain a presence in international markets. The proposal would be especially harmful to U.S. exports because, whereas the Administration takes as its benchmark exporters who only manufacture in the United States, America's most significant exporters usually find that to be successful in foreign markets they need to carry on some of their production in those markets.

Given that severe U.S. limitations are the main reason why U.S. taxpayers often have [foreign tax credits (FTCs)] they cannot claim, it is ironic that the Administration would cite the problem of excess FTCs in arguing for yet another limitation...[[T]he proposal [to replace the export sales rule] would throw a greater double-tax roadblock in the path of many U.S. firms trying to maintain a presence in international markets.

A second Administration rationale is that the United States now has tax treaties with many countries that are intended to reduce double-tax problems. Supposedly, those treaties have made the sales source rule unnecessary. Unfortunately, there are many other countries with which the U.S. does not have tax treaties. With all those other countries, the rule still serves a purpose. Moreover, unless one assumes that tax treaties fully solve international-tax problems, the rule may still be useful even with some countries with whom the U.S. does have tax treaties.

Another perverse consequence of the Administration's proposal is that if it were enacted, it would give some companies now producing in the United States and exporting their American-made products to foreign affiliates a tax motive to move production offshore: in some cases, under an activity based rule, the move would allow the companies to classify more of their income as foreign source, permitting them to claim FTCs on more of the foreign taxes they pay. Another drawback to the Administration's proposed rule is that it would be much more complicated and potentially contentious than the relatively simple and well-established 50-50 allocation rule.

<u>Shorten the carryback period on foreign tax credits (FTCs)</u> When taxpayers have foreign tax credits (FTCs) they cannot claim against current income, they are permitted to carry the credits back up to 2 years and forward up to 5 years. (The procedure is similar to that already discussed with NOLs, but the carryback and carryforward periods are shorter with FTCs.)

Supposedly out of solicitude for the "complexity and administrative burdens" that taxpayers suffer when they have FTCs they cannot claim against current income, the Administration proposes to reduce the carryback period to only 1 year and lengthen the carryforward period to 7 years.[38]

As discussed with the Administration's similar proposal regarding NOLs, a shorter carryback period would not simplify the tax code. Nor is the present carryback period a tax loophole. It allows a more complete view of a taxpayer's overall situation than that provided by arbitrarily dividing the taxpayer's continuing activities into one-year intervals and looking only at the current interval. The effect of the proposal would be to compromise further the ability of U.S. individuals and businesses with foreign source income on which they have paid foreign taxes to recognize those payments in a timely manner for U.S. tax purposes. When a taxpayer is able to carry back an FTC, the credit can be used immediately, producing a current tax saving. In contrast, if FTCs must be carried forward, their present value declines because future tax savings have a lower discounted value than current tax savings due to the value of time.

Hence, by delaying when credits can be claimed, this new limitation, if it becomes law, would effectively raise the marginal tax rate on the results of foreign operations, discouraging such operations. Besides being unfair to U.S. taxpayers, this worsening of the double tax problem already faced by U.S. taxpayers with foreign source incomes would diminish the ability of U.S. companies to compete in foreign markets.

<u>Extend the Federal Unemployment Tax Act (FUTA) surcharge and require monthly deposits</u> The federal government requires employers to pay a tax on the first $7,000 of each employee's wages and salaries. The ostensible purpose of the tax is to help fund the federal-state unemployment compensation system. The net federal tax rate is 0.8% (after a credit), which is divided between a permanent tax of 0.6% and a "temporary" tax surcharge of 0.2%. (States impose additional unemployment taxes on payroll.) The "temporary" surcharge was enacted in 1976 and has been extended ever since. Under current law, the "temporary" 0.2% surtax will lapse at the end of 1998. Generally, employers must pay the 0.8% unemployment tax quarterly. The Administration proposes to extend the 0.2% "temporary" surtax through 2007. The Administration also wants to require employers to pay the unemployment tax monthly if their FUTA tax liability in the previous year was $1,100 or more. The Administration estimates these two changes would bring the U.S. Treasury a 5-year revenue gain of $6 billion.

The Administration argues, "Extending the surtax will support the continued solvency of the Federal unemployment trust funds and maintain the ability of the unemployment system to adjust to any economic downturns."[39] "Accelerating collections," says the Clinton Treasury, "may reduce

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[38] *Ibid.*, p. L-23.

[39] *Ibid.*, p. L-29.

losses...caused by employer delinquency and provide a regular inflow of money to State funds to offset the regular payment of benefits."[40]

In its analysis, the Administration fails to acknowledge that there are several good economic reasons to let the "temporary" surtax finally die. By increasing the after-tax cost of hiring workers, the surtax discourages employers from hiring as many workers as otherwise or paying them as much. Because the FUTA tax applies to the first $7,000 of payroll, the anti-employment effect is especially great for the lowest paid workers. Moreover, by increasing businesses costs, the tax makes it more difficult for businesses to succeed. In short, the tax is a drag on employment and production. Letting the surtax expire would strengthen the economy.

[T]here are several good economic reasons to let the "temporary" [unemployment] surtax finally die...[T]he surtax discourages employers from hiring as many workers as otherwise or paying them as much...[T]he anti-employment effect is especially great for the lowest paid workers. Moreover, by increasing businesses costs, the tax makes it more difficult for businesses to succeed.

The Administration gives the impression that letting the surtax lapse would threaten the solvency of the federal unemployment system. Actually, unemployment taxes have generated billions of dollars more than the program's outlays. The government diverts the surplus collected by the unemployment tax to help pay the government's other bills. (The unemployment trust funds receive, in return, Treasury IOUs.) Thus, the notion that the unemployment tax goes solely to support the unemployment-compensation system is false, and the Administration's warning that unemployment benefits might be threatened if the surtax is not extended is without substance. Indeed, to prevent the amount in one account (the Federal Unemployment Account) from exceeding its statutory maximum, the Administration wants to change the law to double that account's statutory limit. From the point of view of keeping the federal unemployment funds solvent, not only could the 0.2% "temporary" surtax be eliminated but the remaining federal tax of 0.6% could be lowered. The Administration would have been more forthright if it said it wanted to extend the unemployment surtax to help pay for general government operations.

The Administration's request to triple the frequency with which taxes must be paid would greatly increase employers' administrative costs. Because of the interconnections between federal and state management of the unemployment system, it would also sharply raise administrative costs for the states. The Clinton Administration tries to dismiss the paperwork costs by saying, "Limiting the application of acceleration to larger employers would avoid imposing additional requirements on

[40] *Ibid.*, p. L-29.

small businesses."[41] The Administration, however, is defining "larger" to mean all firms with over about 20 employees. By most people's definitions of business size, that actually includes vast numbers of small and medium size businesses. Furthermore, even if, counterfactually, the much more stringent tax payment schedule affected only very large companies, good tax policy calls for simplifying the tax system whenever possible, not cavalierly increasing its complexity for a small speed up in tax collections.[42]

Conclusion

In the last several years, scholars and public policy makers have become more acutely aware of the many severe deficiencies in the current income tax system. The issues are not primarily dollars and cents. The current system is much too complex and confusing. It produces large distortions in the relative prices of different products and activities, causing people to make inefficient production and consumption decisions for tax reasons. It is arbitrary and capricious and, therefore, unfair. Moreover, many taxes are hidden in production costs, which conflicts with the important role taxes should play in making people aware of what they are paying for government services.

The Clinton Administration's proposed tax hikes do not address any of these flaws. On the contrary, the Administration's recommendations would worsen many of the problems. The long list of new rules and restrictions the Administration would impose on taxpayers would add to the tax system's complexity. That would boost taxpayers' already very high paperwork and recordkeeping costs. The changes would intensify tax distortions, particularly tax biases against saving and investment. That means more tax roadblocks impeding the productive activities that generate economic growth. And virtually all of the tax increase would be concealed, which flouts the goal of having readily visible taxes.

Measured against sound tax principles, the tax hikes in the Clinton Administration's budget would be steps in the wrong direction. Moreover, to the extent they advance in Congress, they will

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[41] *Ibid.*, p. L-29.

[42] The discussion in the text assumes the federal unemployment system will remain in place and examines only whether the surtax is needed. A bolder initiative would be to get the government out of the unemployment insurance business. That would mean eliminating the unemployment tax and allowing people who want unemployment insurance to obtain it through the private sector. The government has compiled a deplorable record of inefficiencies and perverse incentives in the many insurance programs it runs, with the hundreds of billions of dollars lost in the federal deposit insurance debacle being only the most extreme example. If it makes sense to provide a particular type of insurance, the private sector can do so more efficiently than the government and structure the program so as to provide much better incentives to policyholders to act responsibly.

impede efforts to achieve fundamental reform of the tax system by shifting attention from core tax principles to the minutiae of collecting more taxes. Members of Congress should ask themselves whether they want to waste this year and maybe next year working on Administration-suggested changes that would leave the tax code worse off and make it harder to achieve improvements.

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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.

March 25, 1997

President Clinton's Proposed Tax Increases

This is a list of the approximately 50 tax increases that the Clinton Administration has requested in the budget it submitted to Congress this year.[43] Also shown are Administration's estimates of each item's revenue yield (in $ billion) for the 5-year period 1998-2002.[44] The items in bold type are those analyzed in depth in IRET Policy Bulletin 70, *Tax Increases By Any Other Name*. Because of the provisions' extremely technical nature and their large number, the IRET Policy Bulletin does not discuss every provision but instead examines a sample.

Item	$ billion
Deny interest deduction on certain debt instruments	0.8
Defer original issue discount deduction on convertible debt	0.2
Limit dividends-received deduction (DRD):	
Reduce DRD to 50 percent	1.7
Eliminate DRD for certain stock	0.2
Modify holding period for DRD	0.1
Extend pro-rata disallowance of tax-exempt interest expense to all corporations	0.2
Require average-cost basis for stocks, securities, etc.	3.0
Require recognition of gain on certain stocks, indebtedness and partnership interests	0.3
Change the treatment of gains and losses on extinguishment	*
Require reasonable payment assumptions for interest accruals on certain debt instruments	1.1
Require gain recognition for certain extraordinary dividends	0.6
Repeal percentage depletion for non-fuel minerals mined on Federal and formerly Federal lands	0.5
Modify loss carryback and carryforward rules	2.9
Treat certain preferred stock as "boot"	0.8
Repeal tax-free conversions of large C corporations to S corporations	0.1
Require gain recognition in certain distributions of controlled corporation stock	0.3
Reform treatment of certain stock transfers	0.7
Expand Subpart F provisions regarding certain income	0.2
Modify taxation of captive "insurance" companies	0.1
Modify foreign tax credit carryback and carryforward rules	1.2
Replace sales source rules with activity-based rules	7.5
Modify rules relating to foreign oil and gas extraction income	0.4
Phase out preferential tax deferral for certain large farm corporations required to use accrual accounting	0.6
Initiate inventory reform:	
Repeal lower of cost or market method	1.5
Repeal components of cost method	0.9
Expand requirement that involuntarily converted property be replaced with property acquired from an unrelated party	*
Place further restrictions on like-kind exchanges involving personal property	0.1
Require registration of certain corporate tax shelters	
Require reporting of payments to corporations rendering services to Federal agencies	0.2
Increase penalties for failure to file correct info returns	0.1
Tighten substantial understatement penalty for large corporations	0.2
Repeal exemption for withholding on gambling winnings from bingo and keno in excess of $5,000	*
Require tax reporting for payments to attorneys	*
Extend oil spill excise tax †	1.1
Impose excise taxes on kerosene as diesel fuel †	0.2
Limit extension of tax credit for producing fuel from a nonconventional source	0.5
Extend and modify FUTA provisions:	
Extend FUTA surtax †	4.7
Accelerate deposit of unemployment insurance taxes	1.3
Extend corporate environmental tax §	4.2
Extend Superfund excise taxes †	3.4
Extend LUST excise taxes †	0.6
Extend aviation excise taxes/new user fees †	32.2
Assess fees for examination of FDIC-insured banks and bank holding companies (receipt effect) †	0.4
Establish IRS continuous levy	1.6
Assess fees for NTSB aviation accident investigation activities †	*
Establish alien labor certification fee †	0.2
Extend and increase FDA user fees †	1.0
Initiate HCFA Medicare survey and certification fee †	*
Increase employee contributions to CSRS and FERS	1.8

* $50 million or less.
† Net of income offsets.
§ Net of deductibility for income tax purposes.

[43] The often enigmatic descriptions of the items come directly from The Office Of Management And Budget, *Budget Of The United States Government: Fiscal Year 1998, Analytical Perspectives* (Washington, DC: Government Printing Office, 1997), Table 3-3, p. 56-58.

[44] The amounts total $79.6 billion. The table in the U.S. Budget gives a total of $76.0 billion. The reason for the difference is that the figure in the budget includes several tax cuts, a change in how the Treasury reimburses Federal Reserve Banks, and a reduced pay increase for federal workers. The list above contains only the tax increases, including some items the Administration calls user fees.