CTJ's Advice to the New Congress

By Robert S. McIntyre

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There are two kinds of things that the new Congress can do regarding taxes. One approach is to come up with some revenue-enhancing tax changes that President Bush might sign. The other is to pass tax increase bills that the president will veto. Both approaches will probably be part of the agenda over the next two years, in that order.

Because the Democrats have promised to restore the antideficit ''pay as you go'' rules that tax cuts must be offset by higher taxes or lower spending, the era of debt-financed tax cuts and spending increases is over. That means that, to avoid big cuts in programs Democrats have promised to maintain or enhance, they must come up with some tax increases that Bush would accept.

The president will certainly balk at anything that attacks his signature program — his huge tax cuts. So to pay for government programs, the Democrats will have to look elsewhere. They could start by passing bills that make it easier to enforce the tax laws we already have and could supplement that by closing unintended or destructive loopholes that are hard to defend on any grounds other than their benefit to major campaign contributors.

One area to focus on especially is offshore tax sheltering, by both multinational corporations and wealthy individuals. That is a growing worldwide problem, as was illustrated by last year's Levin-Coleman Senate report on abusive tax shelters — revelations that the Rolling Stones and U2's Bono have avoided (or evaded) billions of pounds in British taxes through offshore shenanigans, recent IRS cases involving drug company profit shifting into tax havens, and so forth.

To address the problem, Congress should beef up IRS enforcement resources, which have been dramatically cut over the past decade. It should force disclosure from the tax havens, a process that the Bush administration largely aborted early in its tenure but that needs to be pursued again. It needs to clarify the laws, as the Levin-Coleman report recommended, so that tax-haven activity will be automatically presumed to be illegal tax evasion. It needs to enact a tough economic substance rule, so that any transaction entered into mainly for tax avoidance is illegal.

Going further, Congress should think seriously of repealing so-called tax deferral on overseas profits, as President Kennedy proposed back in the early 1960s and John Kerry, D-Mass., proposed in his 2004 presidential campaign. ''Deferral,'' which is really closer to exemption of income that is styled as foreign, is at the heart of offshore tax avoidance. People and companies that have overseas activities and pay taxes on them abroad have little to fear from the end of deferral because they get a tax credit for the foreign income taxes they pay. But without deferral, schemes that allow people and companies to artificially shift U.S. profits offshore will largely be stymied. As a bonus, companies would no longer have a tax incentive to move U.S. jobs to low-tax foreign countries.

While they're at it, the new Congress should also require disclosure of capital gains to the IRS. Right now, small investors in mutual funds get all their capital gains reported, but better-off investors who work through stockbrokers do not. As a result, untold billions of dollars in capital gains go unreported and untaxed.

Anything else that Congress can come up with along those lines, such as scaling back oil company tax breaks that even President Bush opposes, also should be on the table.

Meanwhile, the Democrats have promised to do something about the individual alternative minimum tax. But they face the problem of the enormous cost. Just extending the temporary AMT relief that applied in 2006 (indexed for inflation) for the next four years would cost a staggering $250 billion. There is a way, however, to pay for that extension without breaking the bank: Eliminate the AMT preference for capital gains and dividends. With a few additional tweaks, that approach could be revenue neutral (see, for example, Citizens for Tax Justice, ''A Progressive Solution to the AMT Problem,'' Dec. 14, 2006, available at http://www.ctj.org/pdf/amtsolution.pdf). As an additional bonus, it would restore the AMT's original purpose of requiring the people that are best off to pay a reasonable amount in income tax no matter how many loopholes they enjoy under the regular income tax.

Because that plan is revenue neutral, it doesn't lower the total size of the Bush tax cuts. So President Bush shouldn't be reluctant to sign it — unless he prefers to maintain his promised tax cuts for a few very rich people at the expense of a lot of people who are merely well-off.

That fix for the AMT does, however, have a very serious drawback. Many Democrats want to repeal some or all of the Bush tax cuts for the rich and use the revenues for other purposes, such as deficit reduction or new initiatives. But the AMT plan reduces the Bush tax cuts for the top 1 percent of taxpayers by more than half and uses the revenue to cut taxes for most other people in the top fifth of the income scale. As a result, most of the revenue that could have been raised from repealing the Bush tax cuts for the wealthy would no longer be available for other purposes. Put another way, if you could rescind $193 billion in tax cuts for the top 1 percent over the next four years, would your highest priority be to give that money to people in the top fifth of the income scale?

Finally, many Democrats are champing at the bit to pass bills that attack the Bush tax cuts directly. That's a good idea, but in my view, Democrats should wait until the election year of 2008 to force the president into veto mode.