September 19, 2011
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CTJ Citizens for Tax Justice

Revenue Provisions in President's Jobs Bill

The American Jobs Act proposed by President Barack Obama includes provisions to offset its estimated $447 billion cost by taxing wealthy individuals, investment fund managers, and profitable companies, mainly oil and gas companies. The vast majority of the revenue would be raised by the provision to limit the value of tax deductions and exclusions for high-income people.

Limit Deductions and Exclusions for the Wealthy

Most of the bill's cost would be offset by a provision limiting the tax savings from each dollar of certain deductions and exclusions to 28 cents.

■ Only 2.3 percent of taxpayers would be affected by the limit on deductions and exclusions in 2013.

■ According to the administration this provision would raise $400 billion over ten years.

■ Those who would pay more under this provision are among the richest five percent of taxpayers, and 75 percent of the tax increase would be paid by the richest one percent of taxpayers.

President's Proposal to Limit Deductions and Exclusions to 28%
Impact in 2013 in the United States

Income Group	Average Income	Percent with Tax Increase	Average Tax Increase	Tax Hike as % of Income	Share of Tax Increase
Lowest 20%	$ 13,972	—	$ —	—	—
Second 20%	28,157	—	—	—	—
Middle 20%	45,225	—	—	—	—
Fourth 20%	74,252	—	—	—	—
Next 15%	128,389	—	—	—	—
Next 4%	275,151	34.4%	1,430	0.5%	24.8%
Top 1%	1,472,933	90.6%	17,382	1.2%	75.2%
ALL	$ 76,142	2.3%	$ 228	0.3%	100.0%

Citizens for Tax Justice, September 2011

■ Those among the richest one percent of taxpayers would have an average tax increase equal to 1.2 percent of their total income.

Like previous versions of this proposal offered by the Obama administration, this provision would limit the tax savings of each dollar of itemized deductions claimed by a wealthy person to 28 cents. This version of the proposal is expanded to also limit the value of certain "above-the-line" deductions and certain tax exclusions in the same way.

Under current law, in 2013 an individual in the top income tax bracket (which has a rate of 39.6 percent), will save nearly 40 cents for each dollar of deductions or exclusions. An individual in the next bracket down, the 36 percent income tax bracket, would save 36 cents for each dollar of deductions or exclusions. The lower income tax brackets have rates of 28 percent or less, so people in lower income tax brackets are not affected by this proposal.

The tax increase would not apply to any married couple with adjusted gross income (AGI) below $250,000 or single taxpayer with AGI below $200,000. The proposal seems to assume that in 2013 President Obama's tax plan would be in effect, which is designed to ensure that no taxpayers can be affected by the top two income tax brackets (which will have rates of 36 percent and 39.6

percent) unless they have AGI above those levels.[1]

Deductions and exclusions provide subsidies for certain activities (like buying a home or giving to charity) through the tax system. But they subsidize these activities at higher rates for wealthy families than they do for middle-income families. The President's proposal would reduce, but not eliminate, this unfairness.

For example, the deduction for home mortgage interest is supposed to encourage home ownership, but it provides more average dollar benefits to higher-income people. People rich enough to be in the 39.6 percent income tax bracket in 2013 may save almost 40 cents for each dollar they can deduct in mortgage interest.[2] Middle-income families are generally in the 15 or 25 percent tax bracket. These families save only 15 cents or 25 cents for each dollar they deduct in mortgage interest.

If a member of Congress proposed a program to encourage home ownership through direct subsidies, with larger percentage subsidies going to rich families than middle-income families, we would say that's absurd. But that's exactly how deductions and exclusions work as subsidies.[3]

Under the President's proposal, this unfairness would be lessened because high-income people would only save 28 cents, rather than 40 cents, for each dollar of deductions or exclusions.[4]

People filing their federal income taxes are allowed deductions to lower their taxable income. They can either take a "standard deduction" or choose to "itemize" their deductions. Most people take the standard deduction, but better-off families typically itemize. All of the itemized deductions would be affected by this proposal for taxpayers in the top two income tax brackets.[5]

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[1]The estimates here show the impact of this proposal assuming the President's overall tax plan is in effect in 2013. Under the President's tax plan, the top two income tax rates would be allowed to revert to 36 percent and 39.6 percent, but the rate reductions for the lower income tax rates would be made permanent.

[2]The mortgage interest deduction is limited to the interest on $1 million in mortgage debt, so high-income people may not be able to deduct all of their mortgage interest.

[3]On the other hand, some itemized deductions, such as the deduction for state and local taxes, can be defended as appropriate in determining taxpayers' ability to pay taxes.

[4]Many of the wealthy taxpayers whose deductions and exclusions are targeted by the proposal would also experience a change in their alternative minimum tax (AMT). The AMT is a backstop tax, meaning it forces well-off people who effectively reduce their taxable income with various deductions and exclusions to pay some minimal tax. If a tax change only increases the regular income tax and not the AMT, some taxpayers who currently pay AMT will not be affected at all. Very generally, one of the AMT changes in the proposal essentially ensures that the increase in a taxpayer's regular income tax would also be applied to the AMT to ensure that the tax increase shows up on the final income tax bill. The other AMT change would limit the savings for each dollar of deductions or exclusions to 28 cents for those whose income is within the "phase-out range" for the exemption that prevents most people from being affected by the AMT. The impacts of these changes are included in the estimates shown here.

[5]When President Obama put forward his previous version of this proposal in 2009, some lawmakers expressed concern that it would hurt non-profits because it would reduce the tax subsidy for charitable donations by wealthy taxpayers. A report from the Center on Budget and Policy Priorities concluded that this proposal would only reduce charitable giving by around 1.9 percent. That's partly because only a small group of wealthy taxpayers are affected, and they only account for a fraction of the total charitable giving (about 17 percent) in the United States. Using previous studies on the way tax rates impact charitable giving, they estimated that this fraction of charitable giving will be reduced somewhat, but the overall impact on donations will be a reduction of only 1.9 percent. See

The proposal would also limit in the same way some, but not all, "above-the-line" deductions, which are deductions that taxpayers are allowed to claim even if they use the standard deduction. The above-the-line deductions limited by this proposal include the deduction for health insurance for self-employed individuals, the deduction for domestic manufacturing (affecting certain individuals who own businesses), deductions related to moving expenses, student loan interest, health savings accounts and others.

The proposal would also limit certain tax exclusions. Exclusions provide the same sort of benefit as deductions, the only difference being that they are not counted as part of a taxpayer's income in the first place (and therefore do not need to be deducted). Just as with deductions, a dollar of income excluded will save a person in the top income tax bracket nearly 40 cents under current law, and 28 cents under the President's proposal.

The tax exclusions limited under this proposal are the exclusion for tax-exempt interest from state and local bonds, the exclusion for certain earnings of Americans overseas, and the exclusion for employer-provided health care.[6]

Close the "Carried Interest" Loophole

The jobs bill would also eliminate the loophole that allows certain investment fund managers to enjoy the low capital gains tax rate for "carried interest," which is income that is not truly capital gains at all but rather is compensation for their work.

Some businesses, primarily private equity, real estate, and venture capital, use a technique called a "carried interest" to compensate their managers. Instead of receiving wages, the managers get a share of the profits from investments that they manage without having to invest their own money. The tax effect of this arrangement is that the managers pay taxes on their compensation at the 15 percent rate for capital gains instead of the ordinary income tax rates (up to 35 percent in 2011 and 2012) that normally apply to wages and other compensation.

Income in the form of carried interest can run into the hundreds of millions (or even in excess of a billion dollars) a year for individual fund managers. Arguments that "carried interest" are capital gains rather than compensation for work are unfounded for several reasons:

The fund managers don't invest their own money. They get a share of the profits in exchange for their financial expertise. If the fund loses money, the managers can walk away without any cost.

Paul N. Van de Water, "Proposal to Cap Deductions for High-Income Households Would Reduce Charitable Contributions by Only 1.9 Percent ," Center on Budget and Policy Priorities, revised March 31, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2700.

[6]Efforts to limit the exclusion for employer-provided health care during the health care debate were controversial. This proposal may be much less controversial because it is designed to raise taxes on only the richest Americans, whereas the proposals debated in 2009 and 2010 affected more taxpayers and targeted health plans because of their costs.

A "carried interest" is much like executive stock options. When corporate executives get stock options, it gives them the right to buy their company's stock at a fixed price. If the stock goes up in value, the executives can cash in the options and pocket the difference. If the stock declines, then the executives get nothing. But they never have a loss. When corporate executives make money from their stock options, they pay both income taxes at the regular rates and payroll taxes on their earnings.

Private equity managers admit in writing that "carried interest" is compensation. In a filing with the Securities and Exchange Commission in connection with taking its management partnership public, the Blackstone Group, a leading private equity firm, had this to say in 1997 about its activities (in order to avoid regulation under the Investment Act of 1940):

> "We believe that we are engaged primarily in the business of asset management and financial advisory services and not in the business of investing, reinvesting, or trading in securities.
>
> We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services."

Eliminate Breaks for Oil and Gas

The jobs bill also includes provisions to eliminate or reduce tax subsidies for oil and gas companies. Ending these tax subsidies is justified on environmental grounds as well as on grounds of economic efficiency and fairness. Here are some of the most significant of these provisions.

Bar Oil and Gas Companies from Using the Manufacturing Tax Deduction

The manufacturing tax deduction was added to the law in 2004 and allows companies to deduct 9 percent of their net income from domestic production. Some might wonder why oil and gas companies can use a deduction for "manufacturing" in the first place. But Congress specifically included "extraction" in the definition of manufacturing so that it included oil and gas production, obviously at the behest of the industry.

Repeal Expensing of Intangible Drilling Costs

The "intangible" costs of exploration and development include wages, costs of using equipment for drilling, and the costs of materials that get used up during the process of building wells. Most businesses write off such expenses over the useful life of the property, but oil companies, thanks to their lobbying clout, get to deduct these expenses immediately.

Repeal Percentage Depletion for Oil and Natural Gas

Most businesses must write off the actual costs of equipment and other property that declines in value over a period of time (albeit faster than things actually wear out). If oil companies had to do the same, they would write off the cost of oil fields until the oil was depleted. Instead, percentage depletion allows certain types of oil and gas producers to simply deduct a flat percentage of gross revenues. The percentage depletion deductions can actually exceed costs and can zero out all federal taxes for oil and gas companies. The Energy Policy Act of 2005 actually expanded this provision to allow more companies to enjoy it.

Reduce the break for amortization of geological and geophysical expenditures. As already explained, most businesses write off the actual cost of property over its useful life (until it wears out). If a business can amortize (write off the costs) more quickly, that means it receives tax deductions earlier, making them much more valuable. The amortization over a two-year period of the costs of searching for oil was introduced in the Energy Policy Act of 2005 and is available even when oil and gas is discovered. The tax cut bill Congress passed in 2006 changed the rule to allow a five-year amortization. The jobs bill would change the rule to allow seven-year amortization.

Modify Rules for "Dual Capacity" Taxpayers

Dual capacity taxpayers generally are corporations that make two types of payments to foreign governments. One type of payment is some form of corporate income tax, while another type is a royalty or fee or other type of payment made in return for a particular economic benefit. The U.S. tax code allows American corporations to take a credit for any corporate income taxes they pay to foreign governments, to avoid double-taxation of foreign income. The problem is that the current rules sometimes allow these corporations to, in effect, take foreign tax credits for non-tax payments they make to foreign governments. This of course has nothing to do with avoiding double-taxation, which is the sole purpose of the foreign tax credit. The jobs bill would change the rules to end this practice, which is often used by oil and gas companies, as well as others (particularly mining companies).