Citizens for Tax Justice

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Contact: Steve Wamhoff
(202) 299-1066 x33

The American Jobs and Closing Tax Loopholes Act of 2010 (a.k.a. the "Extenders" Bill) Would Boost the Economy and Improve Tax Fairness

The chairmen of the House and Senate tax-writing committees have recently released a summary of "H.R. 4213," often called the "extenders" bill because it would extend several economic relief programs and small tax breaks. The bill includes an extension of unemployment insurance and COBRA health care benefits for the unemployed, Medicaid funding for states, TANF jobs and emergency funding for states and other measures needed to speed up the economic recovery. The spending is mostly considered emergency spending to address the economic crisis, and therefore does not need to be paid for according to Congress's budget procedures.

This bill also includes the "tax extenders," which are extensions of several short-term tax breaks (mostly for business) that Congress enacts every year or so. The cost of these tax breaks would be offset with several provisions to close tax loopholes for corporations that shift profits offshore, investment fund managers who currently pay lower tax rates than their secretaries, and business people who use a tax dodge to avoid their Social Security and Medicare taxes.

While we have never supported the "tax extenders," we believe that this is a more responsible approach than Congress used in the past, when the tax extenders were deficit-financed. We also believe that the loophole-closing provisions used to pay for them will enhance tax fairness. For these reasons, we believe passage of this bill would be a major victory in that it shows Congress is finally putting the economic needs of ordinary Americans ahead of tax cuts for the wealthy and powerful.

Here are some of the largest loophole-closing provisions in the bill.

Closing Foreign Tax Loopholes
10-Year Revenue Gain: $14.5 billion

When American individuals and corporations make money in a foreign country, they must pay U.S. taxes on that income (although corporations get to defer those U.S. taxes until they bring that income back to the U.S.). But they get a credit against their U.S. taxes for any taxes paid on that income to the foreign government. This foreign tax credit (FTC) makes sense in theory, because it prevents double-taxation of foreign income earned by U.S. taxpayers abroad.

The problem is that some corporations have figured out ways to get FTCs on income that is not taxable in the U.S. or that exceed the U.S. taxes they would pay on that income, meaning the FTCs ultimately are used to reduce U.S. taxes on the corporations' U.S. income. This has nothing to do with avoiding double-taxation. It also means that corporations are investing (at least on paper) in foreign countries just to reduce their U.S. taxes on the income they're making here in the U.S.

The proposals included in the extenders bill to close foreign tax loopholes are essentially measures to prevent corporations from using FTCs to reduce their U.S. taxes on their U.S. income. They would prevent the corporations from using FTCs on income that is not taxable in the U.S. or using FTCs that exceed the U.S. taxes that would apply to the income if it was generated in the U.S. While some of the foreign tax loophole-closers are significantly scaled back versions of stronger proposals put forward by the Obama administration, they are nonetheless important steps in the right direction.

Closing (Most of) the "Carried Interest" Loophole
10-Year Revenue Gain: $18.7 billion

The "carried interest" loophole allows certain investment fund managers to disguise part of their compensation as capital gains and thus enjoy the preferential income tax rate for capital gains rather than pay the ordinary tax rates that everyone else pays on their compensation. The result is that investment fund managers who sometimes earn hundreds of millions of dollars a year pay at lower rates than their secretaries. Congress appears poised to finally clamp down on this loophole, although unfortunately this proposal would not eliminate it entirely.

Carried interest is a share of the profits on an investment that are promised to the person managing the investment as compensation for his or her services. It is not a return on an investment that the fund manager made himself.[1] (To the extent that an investment fund manager receives a capital gain on an investment he made with his own money, that would continue to be treated as a capital gain, and thus subject to the lower income tax rate, regardless of what Congress does with the carried interest loophole.)

The general rule in the U.S. is that individuals who receive a capital gain on an investment they made with their own money get to enjoy a lower tax rate — a top rate of 15 percent, which will revert to 20 percent after the Bush tax cuts expire at the end of this year. The ordinary income tax rate that would normally apply to compensation for people with such high incomes is 35 percent, which will revert to 39.6 percent after the Bush tax cuts expire at the end of this year.

A secretary working for an investment fund manager might pay income taxes on a portion of his income at 15 percent or 25 percent, and must pay payroll taxes of around 15 percent on all of his income. The investment fund manager currently pays income taxes of just 15 percent on the carried interest (which may run into the hundreds of millions of dollars) and pays no payroll taxes on it.

The hedge fund managers, buyout fund managers, venture capitalists and other types of fund managers who want to preserve this loophole have done an incredibly effective job of confusing this issue. They have pointed out that the investment fund managers often do invest

[1]Citizens for Tax Justice, "Myths and Facts about Private Equity Fund Managers — and the Tax Loophole They Enjoy," July 2007. http://www.ctj.org/pdf/privateequity071907.pdf

their own money in the deals they make. This is true, but it's irrelevant because no one is proposing to change the treatment of capital gains on investments they made with their own money. The investment fund managers then go on to say that in addition to their own money, they also invest their time and labor and therefore have "sweat equity" in the investments. But surely many, many people have invested their time and labor, rather than their money, into building an enterprise. Most of us just call that "having a job," and we don't get a tax break as a result of it.

The investment fund managers also argue that this tax break is necessary to encourage risky investments that would not otherwise be made. Why we should subsidize investments that are risky (particularly in light of the economic tumult of the last few years) is never explained. It is irrelevant anyway, because the actual investors (the people or entities putting up the money) are not affected, since this measure only affects the tax treatment of the people paid to manage the money.

Finally, the fund managers argue that they will have to charge more for their services if they must pay income taxes at the same rates as other people with comparable levels of compensation. Even if that was true, it would be nothing more than an admission that they are engaged in an activity that is not driven by market forces but by a distortion caused by a government subsidy provided through the tax code. In any event, this cannot possibly be true because if these fund managers could charge more, they would do it now. There have been instances when their tax rate was reduced (in 1997 and 2003 when the capital gains rate was cut) and there is no evidence that investment fund managers charged *less* for their services as a result of those tax cuts.

The provision included in the extenders bill would eventually require that 75 percent of an investment fund manager's carried interest be taxed as "ordinary income," meaning subject to ordinary income tax rates. They would still be allowed to pay the preferential capital gains tax rate on 25 percent of their carried interest. The continuation of this loophole for 25 percent of carried interest makes no policy sense whatsoever, but this provision is still a major step towards tax fairness.

Closing (Most of) the "John Edwards" Loophole for "S Corporations"
10-Year Revenue Gain: $9.6 billion

This provision of the extenders bill would prevent taxpayers from using "S corporations" to avoid paying Social Security and Medicare taxes on their earnings.

Payroll taxes that fund Social Security and Medicare are supposed to be paid on all income from work. The Social Security payroll tax is paid on the first $106,800 in earnings (adjusted each year) and the Medicare tax is paid on all earnings. The employer nominally pays half of these taxes, and the employee pays the other half. (Analysts agree that the employee ultimately pays the entire tax through reduced earnings and benefits). Other types of income (income that is not from work) are not subject to payroll taxes. So, naturally, some taxpayers search for ways to disguise their income from work as non-work income.

One common way is to use an "S corporation," which is a corporation whose profits are not subject to the corporate income tax, but are instead included in the income of its owners. S corporations are not publicly traded and can have no more than 100 owners, which is why some people (erroneously) think they are always small companies.

Someone who owns and runs an S corporation must tell the IRS how much of her income is compensation (meaning it's earned income and therefore subject to Social Security and Medicare payroll taxes) and how much of it is business profits that are not earned income (and thus not subject to payroll taxes). There are rules requiring S corporation owners to categorize a "reasonable" amount of the income as earned income, but these rules are difficult to enforce.

The result is that people form S corporations and then dramatically under-report the extent to which their income is compensation for work. The Government Accountability Office recently found that the amount of payroll taxes lost in this way in tax years 2003 and 2004 (combined) could be around $3 billion.[2]

The most famous example of this was the scheme used by former Senator John Edwards, who actually claimed that his name was an asset, and this asset (rather than his labor) was generating most of the income for his law firm (which was an S corporation).

This provision of the extenders bill would dramatically cut down these abuses. It would address situations in which an S corporation provides a service and generates most of its business based on the reputation or skills or three or fewer people. In other words, if this rule were in place already, John Edwards probably would not have been able to avoid his payroll taxes.

[2]Government Accountability Office, "Actions Needed to Address Noncompliance with S Corporation Rules," December 15, 2009, GAO-10-195. http://www.gao.gov/new.items/d10195.pdf