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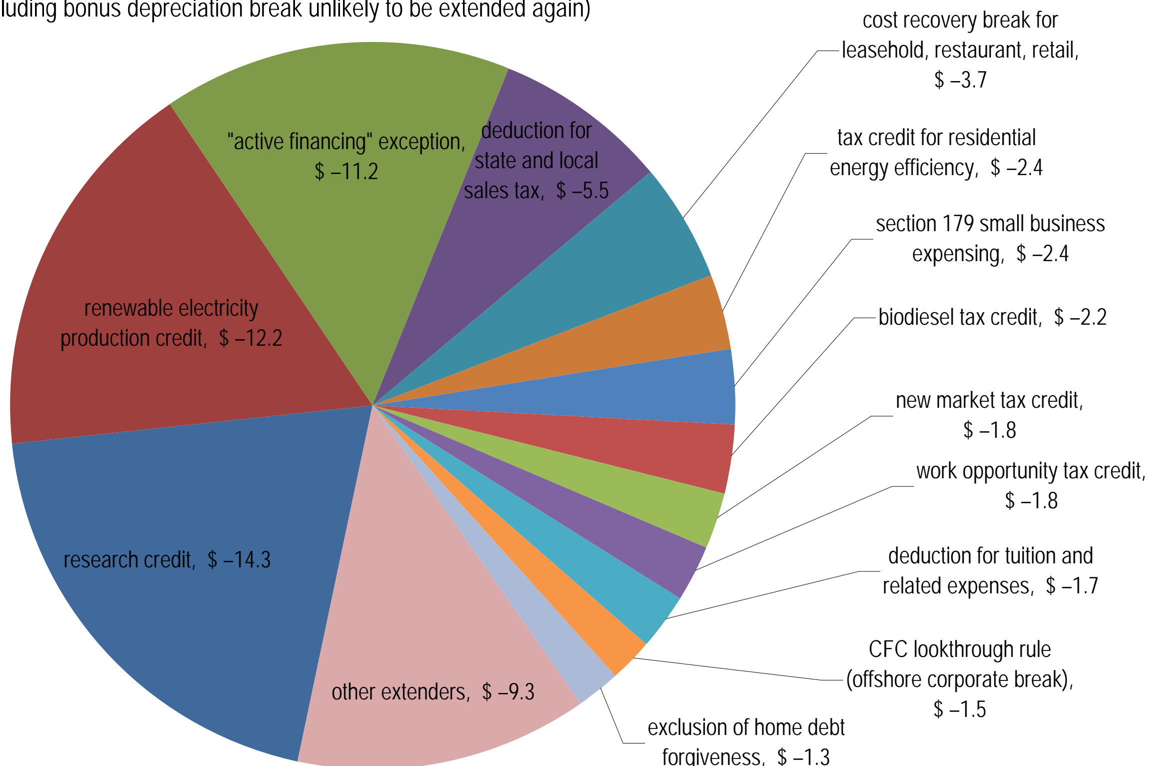
Congress Should Offset the Cost of the “Tax Extenders,” or Not Enact Them At All

Congress should end its practice of passing, every couple of years, a so-called “tax extenders” bill that reenacts a laundry list of tax breaks that are officially temporary and that mostly benefit corporations, without offsetting the cost. It is entirely inappropriate that lawmakers refuse to fund infrastructure repairs or Head Start slots for children unless the costs are offset, while routinely extending these tax breaks without paying for them. If lawmakers want to enact tax breaks for businesses, then they should offset the costs by closing tax loopholes that benefit businesses. This report explains that none of the tax extenders can be said to help Americans so much that they should be enacted regardless of their impact on the budget deficit and other, more worthwhile programs.



Source: Joint Committee on Taxation, JCX-1-13.

The tax breaks usually considered part of the "tax extenders" were last enacted as part of the deal addressing the "fiscal cliff" in January of 2013. At that time most of the provisions were extended one year retroactively and one year going forward, through 2013. As these tax breaks approach their scheduled expiration date at the end of this year, they are again in the news.

The graph on the previous page shows the tax extenders that were enacted as part of the fiscal cliff deal on January 1, 2013, except for the "bonus depreciation" tax break that no one in Congress seems to be advocating for further extension. The total cost of the tax extenders shown in the graph was $71.4 billion over a decade.

The most costly three provisions — the research credit, the renewable electricity production tax credit, and the "active financing" exception — made up over half of the cost of the tax extenders.

As explained below, some of these provisions, like the active financing exception that facilitates offshore tax avoidance by corporations, have no place in our tax code at all. Others, like the research credit, ought to be allowed to expire but could at least be made more effective if Congress took the time to reform them. And still others, like the exclusion of home debt forgiveness costing $1.3 billion, may be well-intended but make up such a small fraction of the overall costs of the legislation that they cannot possibly justify the enactment of this package of tax breaks as a whole.

The January 2013 tax extenders package included 53 separate provisions. The chart on the previous page breaks out the 13 largest and combines the remaining 40 in the category "other extenders." The largest thirteen made up 87 percent of the cost, although many of the provisions that receive public attention (and often ridicule) are among the smaller breaks included in "other extenders," such as the "7-year recovery period for certain motorsports racing track facilities" (the NASCAR tax break), which cost $78 million.

The following sections explain that none of these provisions is so helpful to our economy or our society that lawmakers should feel compelled to enact them again without agreeing on a way to pay for them.

Research Tax Credit
cost of two-year extension: $14.3 billion

The research and experimentation tax credit is a tax subsidy that is supposed to encourage businesses to perform research that benefits society. A recent report from Citizens for Tax Justice explains that the research credit is riddled with problems and should be either reformed dramatically or allowed to expire.[1]

As our report explains, the research credit subsidizes activities that do not benefit society in any clear way and/or subsidizes research that would have taken place even in the absence of

the credit. In order to address this, lawmakers should at least refuse to extend the credit again unless the extension includes three types of reforms.

First, the definition of the type of research activity eligible for the credit must be clarified. One step in the right direction would be to enact the standards embodied in regulations proposed by the Clinton administration, which were later scuttled by the Bush administration. As it stands now, accounting firms are helping companies obtain the credit to subsidize redesigning food packaging and other activities that most Americans would see no reason to subsidize. The uncertainty about what qualifies as eligible research also results in substantial litigation and seems to encourage companies to push the boundaries of the law and often cross it.

Second, Congress must improve the rules determining which part of a company's research activities should be subsidized. In theory, the goal is to subsidize only research activities that a company would otherwise not pursue, which is a difficult goal to achieve. But Congress can at least take the steps proposed by the Government Accountability Office to reduce the amount of tax credits that are simply a "windfall," meaning money given to companies for doing things that they would have done anyway.

Third, Congress must address how and when firms obtain the credit. For example, Congress should bar taxpayers from claiming the credit on amended returns, because the credit cannot possibly be said to encourage research if the claimant did not even know about the credit until after the research was conducted.

Renewable Electricity Production Tax Credit
cost of one-year extension: $12.2 billion

The renewable electricity production tax credit (PTC) subsidizes the generation of electricity from wind and other renewable sources. The credit is 2.3 cents per kilowatt for electricity generated from wind turbines and less for energy produced by other types of renewable sources.

First created in 1992, the PTC is one tax extender that may actually expire. It has been criticized by many conservative lawmakers and organizations that tend to not object to other tax extenders, perhaps because they see wind energy as a competitor to fossil fuels.[2]

Unlike most other tax extenders, the PTC was extended for only one year. However, the cost estimate for the PTC was larger than usual in the fiscal cliff legislation because that law also expanded the PTC by allowing wind turbines (and other such facilities) to qualify so long as their construction began during 2013, whereas before the turbines had to be up and running by the end of the year.

Extending the PTC for another year will cost an estimated $6.1 billion.[3] This would mean that a two-year extension (comparable to the rest of the provisions that would be extended for two years) would cost about $12 billion. In other words, the PTC is likely to remain the second

most expensive tax extender if one makes an apples-to-apples comparison with the other tax extenders.

"Active Financing" Exception
cost of two-year extension: $11.2 billion

"Subpart F" of the tax code attempts to bar American corporations from "deferring" (delaying) paying U.S. taxes on certain types of offshore profits that are easily shifted out of the United States, such as interest income. The two-year extension of the "active financing" exception to subpart F, at a cost of $11.2 billion, allows American corporations to defer paying taxes on offshore interest even though such income is often really earned in the U.S. or other developed countries, but has been artificially shifted into an offshore tax haven in order to avoid taxes.

The "active financing" exception should never be a part of the tax code.

The U.S. technically taxes the worldwide corporate profits, but American corporations can "defer" (delay indefinitely) paying U.S. taxes on "active" profits of their offshore subsidiaries until those profits are officially brought to the U.S. "Active" profits are what most ordinary people would think of as profits earned directly from providing goods or services.

"Passive" profits, in contrast, include dividends, rents, royalties, interest and other types of income that are easier to shift from one subsidiary to another. Subpart F tries to bar deferral of taxes on such kinds of offshore income. The so-called "active financing exception" makes an exception to this rule for profits generated by offshore financial subsidiaries doing business with offshore customers.

The active financing exception was repealed in the loophole-closing1986 Tax Reform Act, but was reinstated in 1997 as a "temporary" measure after fierce lobbying by multinational corporations. President Clinton tried to kill the provision with a line-item veto; however, the Supreme Court ruled the line-item veto unconstitutional and reinstated the exception. In 1998 it was expanded to include foreign captive insurance subsidiaries. It has been extended numerous times since 1998, usually for only one or two years at a time, as part of the tax extenders.

As explained in a report from Citizens for Tax Justice, the active financing exception provides a tax advantage for expanding operations abroad. It also allows multinational corporations to avoid tax on their worldwide income by creating "captive" foreign financing and insurance subsidiaries.[4] The financial products of these subsidiaries, in addition to being highly fungible and highly mobile, are also highly susceptible to manipulation or "financial engineering," allowing companies to manipulate their tax bill as well.

As the report explains, the exception is one of the reasons General Electric paid, on average, only a 1.8 percent effective U.S. federal income tax rate over ten years. G.E.'s federal tax bill is

lowered dramatically with the use of the active financing exception provision by its subsidiary, G.E. Capital, which Forbes noted has an "uncanny ability to lose lots of money in the U.S. and make lots of money overseas."[5]

Deduction for State and Local Sales Taxes
cost of two-year extension: $5.5 billion

Permanent provisions in the federal personal income tax allow taxpayers to claim itemized deductions for property taxes and income taxes paid to state and local governments. Long ago, a deduction was allowed for state and local sales taxes, but that was repealed as part of the 1986 tax reform. In 2004, the deduction for sales taxes was brought back temporarily and extended several times since then. Because the deduction for state and local sales taxes cannot be taken along with the deduction for state and local income taxes, in most cases, taxpayers will take the sales tax deduction only if they live in one of the handful of states that have no state income tax.

Taxpayers can keep their receipts to substantiate the amount of sales taxes paid throughout the year, but in practice most people use rough calculations provided by the IRS for their state and income level. People who make a large purchase, such as a vehicle or boat, can add the tax on such purchases to the IRS calculated amount.

Impact of Sales Tax Deduction

Impact in 2011 if current income tax rates and phase-outs were in effect that year.

Adjusted Gross Income	Number Claiming Deduction	Average Deduction	Average Tax Change	Share of Tax Benefit
Less than $60,000	5,587,000	$ 920	$ –100	19%
$60,000 — $75,000	1,174,000	1,370	–240	9%
$75,000 — $100,000	1,412,000	1,690	–300	14%
$100,000 — $200,000	1,984,000	2,100	–490	32%
Over $200,000	718,000	3,740	–1,130	26%
ALL	**10,876,000**	**$ 1,470**	**$ –280**	**100%**

The number claiming the deducion and the average deduction are from IRS Statistics of Income for 2011, the most recent data. Other numbers are estimated with the Institute on Taxation and Economic Policy (ITEP) tax model.

There are currently nine states that have no broad-based personal income tax and rely more on sales taxes to fund public services. Politicians from these states argue that it's unfair for the federal government to allow a deduction for state income taxes, but not for sales taxes. But this misses the larger point. Sales taxes are inherently regressive and this deduction cannot remedy that since it is itself regressive. To be sure, lower-income people pay a much higher percentage of their incomes in sales taxes than the wealthy. But lower-income people also are unlikely to itemize deductions and are thus less likely to enjoy this tax break. In fact, the higher your income, the more the deduction is worth, since the amount of tax savings depends on your tax bracket.

The table above includes taxpayer data from the IRS for 2011, the most recent year available, along with data generated from the Institute on Taxation and Economic Policy (ITEP) tax

model to determine how different income groups would be affected by the deduction for sales taxes in the context of the federal income tax laws in effect today.

As illustrated in the table, people making less than $60,000 a year who take the sales-tax deduction receive an average tax break of just $100, and receive less than a fifth of the total tax benefit. Those with incomes between $100,000 and $200,000 enjoy a break of almost $500 and receive a third of the deduction, while those with incomes exceeding $200,000 save $1,130 and receive just over a fourth of the total tax benefit.

15-Year Cost Recovery Break for Leasehold, Restaurants, and Retail
cost of two-year extension: $3.7 billion

Firms are allowed to deduct their business expenses each year. Capital expenses (expenditures to acquire assets that generate income over a long period of time) usually must be deducted over a number of years to reflect their ongoing usefulness. So the expenses that go towards developing a capital asset, like improvements in a building used for the business, will be deducted over several years. In most cases firms would rather deduct capital expenses right away rather than delaying those deductions, because of the time value of money, i.e., the fact that a given amount of money is worth more today than the same amount of money will be worth if it is received later. For example, $100 invested now at a 7 percent return will grow to $200 in ten years.

Congress has showered all sorts of businesses with breaks that allow them to deduct the cost of developing capital assets more quickly than they actually wear out. This particular tax extender allows certain businesses to write off the cost of improvements made to restaurants and stores over 15 years rather than the 39 years that would normally be required.

Like the rest of the tax extenders, this provision has been reenacted routinely by Congress without any provision to offset the costs, even as Congress cuts back on investments like nutrition assistance and Head Start. It is unclear why helping restaurant owners and store owners improve their properties should be seen as more important than nutrition and education for low-income children.

Tax Credit for Residential Energy Efficiency
cost of two-year extension: $2.4 billion

The section 25C tax credit for energy improvements is capped at $500 and can go towards the costs of improving doors, windows, insulation, roofing or other improvements that make a home more energy efficient. While this is a perfectly reasonable role for the federal government to play, there is no obvious reason why it is best carried out through the tax code.

Section 179 Small Business Expensing
cost of two-year extension: $2.4 billion

As already noted, Congress has showered businesses with several types of depreciation breaks, that is, breaks allowing firms to deduct the cost of acquiring or developing a capital asset more quickly than that asset actually wears out. There are massive accelerated depreciation breaks that are a permanent part of the tax code as well as many that are (at least officially) temporary, like section 179, which allows smaller businesses to write off most of their capital investments immediately (up to certain limits).

A report from the Congressional Research Service reviews efforts to quantify the impact of depreciation breaks and explains that "the studies concluded that accelerated depreciation in general is a relatively ineffective tool for stimulating the economy."[6]

One positive thing that can be said about section 179 is that it is more targeted towards small business investment than any of the other tax breaks that are alleged to help small businesses.

Section 179 allows firms to deduct the entire cost of a capital purchase (to "expense" the cost of a capital purchase) up to a limit. The most recent tax extenders package included provisions that allowed expensing of up to $500,000 of purchases of certain capital investments (generally, equipment but not land or buildings). The deduction is reduced a dollar for each dollar of capital purchases exceeding $2 million, and the total amount expensed cannot exceed the business income of the taxpayer.

These limits mean that section 179 generally does not benefit large corporations like General Electric or Boeing, even if the actual beneficiaries are not necessarily what ordinary people think of as "small businesses."

There is little reason to believe that business owners, big or small respond to anything other than demand for their products and services. But to the extent that a tax break could possibly prod small businesses to invest, section 179 is somewhat targeted to accomplish that goal.

[1]Citizens for Tax Justice, “Reform the Research Credit – Or Let It Die,” December 4, 2013. www.ctj.org/ctjreports/2013/12/reform_the_research_tax_credit_--_or_let_it_die.php

[2] “Coalition to Congress: End the Wind Production Tax Credit,” September 24, 2013, http://www.eenews.net/assets/2013/09/24/document_pm_02.pdf; Nicolas Loris, “Let the Wind PTC Die Down Immediately,” October 8, 2013. http://www.heritage.org/research/reports/2013/10/wind-production-tax-credit-ptc-extension

[3] Julian Hattem, “GOP Questions Need for Wind Farm Tax Credit,” October 02, 2013. http://thehill.com/blogs/regwatch/energyenvironment/326117-wind-tax-credit-comes-under-fire-

[4] Citizens for Tax Justice, “Don’t Renew the Offshore Tax Loopholes,” August 2, 2012. www.ctj.org/ctjreports/2012/08/dont_renew_the_offshore_tax_loopholes.php

[5] Christopher Helman, “What the Top U.S. Companies Pay in Taxes,” Forbes, April 1, 2010, http://www.forbes.com/2010/04/01/ge-exxon-walmart-business-washington-corporate-taxes.html.

[6] Gary Guenther, “Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects,” Congressional Research Service, September 10, 2012. http://www.fas.org/sgp/crs/misc/RL31852.pdf

APPENDIX: Tax Extenders Organized by Category According to Joint Committee on Taxation

The Joint Committee on Taxation (JCT), which provides the official cost estimates of tax proposals before Congress, divided the tax extenders legislation in the fiscal cliff bill into three separate categories: tax extenders for individuals, tax extenders for businesses, and energy tax extenders. In reality, businesses benefit from many of tax extenders that are not categorized as business extenders. (For example, the wind electricity production credit goes to companies that own wind turbines.)

Below is a breakdown of the tax extenders in the fiscal cliff legislation as categorized by JCT.