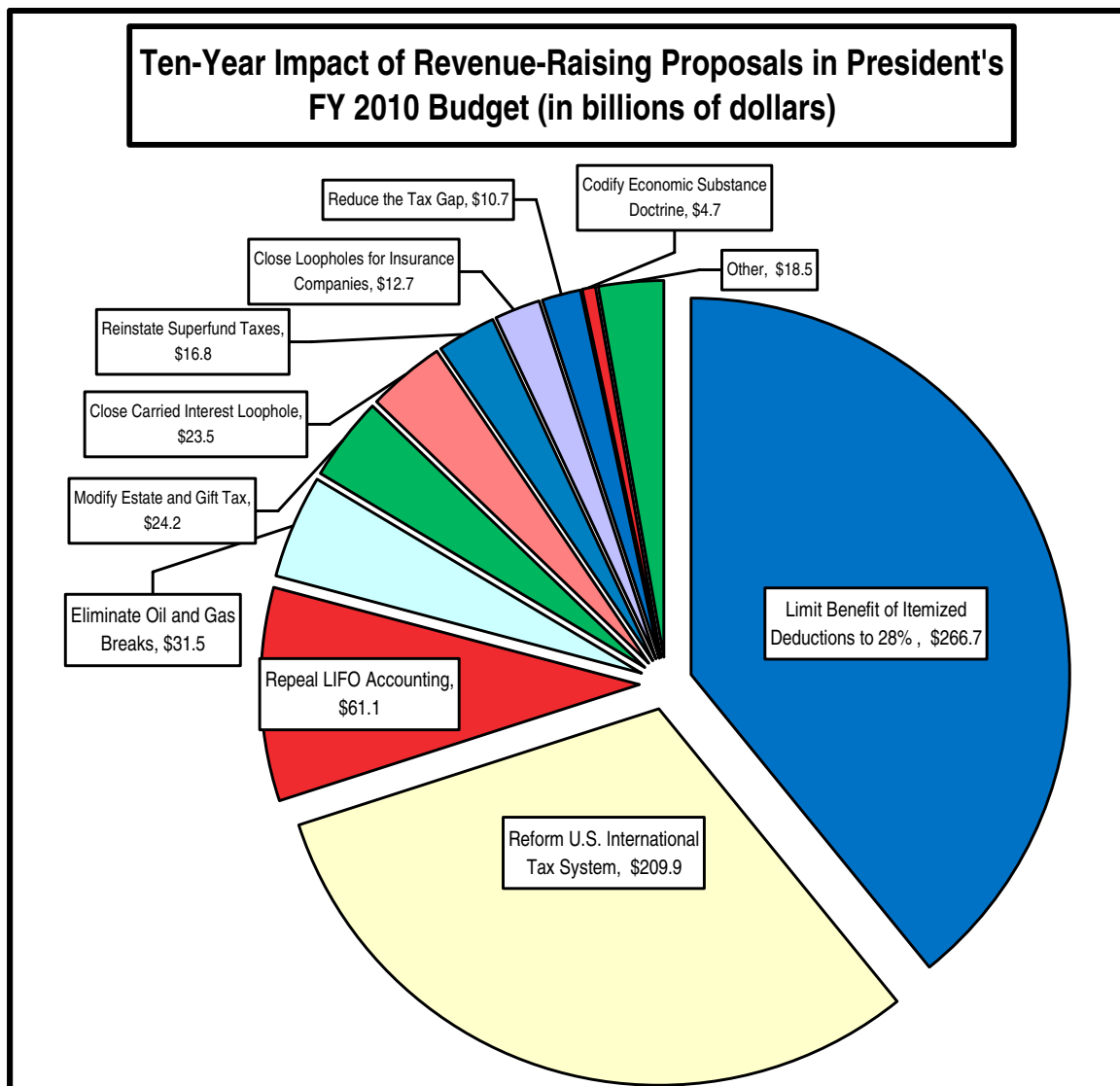


## President Obama's Proposals to Raise Revenue

On May 11, the Treasury Department released new details on President Obama's proposed changes to the tax code. In addition to extending the Bush tax cuts for all but the richest Americans and making permanent many of the tax cuts in the recently enacted economic recovery act, the President would also make many changes that would raise revenue by closing loopholes, blocking tax avoidance schemes and making the tax code more progressive.



Source: Treasury Department, "Green Book," May 11, 2009, and calculations by Citizens for Tax Justice.

Some of the revenue-raising measures in the President’s budget are intended to fund health care reform, including the new limit on itemized deductions, measures to reduce the “tax gap,” measures to block estate tax avoidance practices and loophole-closers related to the insurance and financial industries.

Other revenue proposals in the President’s budget are intended to fund other initiatives or to reduce the budget deficit. For example, over a third of the revenue raised from the President’s proposals to reform the U.S. international tax system would be used to make permanent the tax credit for research and experimentation, while the rest of the revenue from these proposals is intended to help reduce the deficit.

The following is a description of the most significant revenue-raising measures among the President’s proposals.

**Limitation on Tax Benefit of Itemized Deductions to 28 Percent for Wealthy Taxpayers  
Ten-Year Revenue Gain: \$266.7 Billion**

The President’s budget includes a proposal to limit the tax benefit of itemized deductions to help pay for health care reform. Under the proposal, each dollar of itemized deductions claimed will save a taxpayer a maximum of 28 cents, down from the maximum of almost 40 cents that will otherwise apply in years after 2010.

The tax benefit of itemized deductions depends on the individual’s tax bracket. An extremely high-income American pays income taxes at a top rate of 39.6 percent (in years after 2010, since the Bush tax cuts are scheduled to expire then). This means that every dollar of itemized deductions claimed by a very high-income person results in almost 40 cents in savings. A middle-income person in the 10 percent income tax bracket only saves 10 cents for every dollar of itemized deductions claimed. The President’s proposal would reduce, but not eliminate, this imbalance.

The Obama administration says that limiting the tax benefit to 28 percent will raise \$266.7 billion through 2019.

The nearby table illustrates that this tax increase would mainly impact those who have benefitted the most from the tax policies of former President Bush — the richest one percent of taxpayers.

**Reform U.S. International Tax Rules  
Ten-Year Revenue Gain: \$209.9 Billion**

The President proposes to make changes to both corporate and personal income taxes in order to protect the U.S. tax base on U.S. income.

**Impact of Proposal to Limit Benefit of Itemized Deductions to 28%, in 2011**

Income Group	Average Income	Average Tax Increase	Share of Tax Increase
Lowest 20%	\$ 12,850	\$ 0	0.0%
Second 20%	25,867	0	0.0%
Middle 20%	41,875	0	0.0%
Fourth 20%	68,769	3	0.4%
Next 10%	105,120	1	0.1%
Next 5%	148,615	17	0.6%
Next 4%	261,424	371	10.8%
Top 1%	1,467,185	12,064	88.0%
<b>ALL</b>	<b>\$ 71,803</b>	<b>\$ 135</b>	<b>100.0%</b>
Bottom 60%	\$ 26,863	\$ 0	0.0%

Source: ITEP Microsimulation Model, March 2009

The current tax system fails to prevent individuals and corporations from abusing the existing rules related to offshore income and investments. As a result, many wealthy and powerful Americans do not pay their fair share to support American society. Some of the offshore tax abuses constitute tax *avoidance*, meaning practices that are not necessarily illegal but which clearly manipulate the tax laws in ways that Congress never intended

to allow. Other offshore abuses constitute tax *evasion*, meaning practices that are definitely illegal and which usually involve individuals who hide their income from the IRS.

Whether illegal or legal, many offshore tax abuses involve offshore transactions that exist on paper only, meaning no productive activities are actually being carried out in the foreign country. The investments or transactions are merely schemes to avoid or evade U.S. taxes.

The administration projects that it can save \$210 billion over a decade with its proposed reforms to the U.S.'s international tax rules. The following are some of the largest (in terms of revenue impact) components of the President's proposal to reform the U.S.'s international tax rules.

#### *Reform "Check-the-Box" Rules.*

U.S. multinational corporations can currently manipulate transfers between their subsidiaries in different countries to make foreign income "disappear." A regulation mistakenly adopted by the Clinton administration in 1996 allows companies to choose whether or not a foreign affiliate will be treated as a separate corporation or as a non-separate entity for tax purposes by simply checking a box on a form. As a result, U.S. companies can easily shift U.S. profits offshore by routing them first through a non-tax-haven country and then to a tax haven. By electing to treat the tax-haven affiliate as a corporation for purposes of the non-tax-haven country's tax system, but as a non-separate entity for U.S. tax purposes, it avoids tax in both the U.S. and the non-tax-haven country. To curb this scheme to shift U.S. profits to tax havens, the President's proposal would require that certain foreign affiliates be characterized as corporations.

#### *Limit U.S. Deductions for the Costs of Earning Untaxed Foreign Profits.*

U.S. multinational companies are allowed to "defer" the U.S. taxes on income generated by their foreign subsidiaries until that income is brought back to the U.S. (until that income is "repatriated"). There are numerous problems with deferral, but it's particularly problematic when a U.S. company defers U.S. taxes on foreign income even while it deducts expenses of earning that foreign income against its U.S. profits. To better protect the U.S. tax base on U.S. profits, the President's proposal would require that U.S. companies defer some deductions for the expenses related to earning income abroad when U.S. taxes on that income are deferred.

#### *Close Loopholes in the Foreign Tax Credit.*

Individuals or companies with income generated abroad get a credit against their U.S. taxes for any taxes paid to a foreign government in order to prevent double-taxation. This makes perfect sense, but unfortunately the credit is sometimes used by corporations for foreign income that is not even taxable in the U.S. and at other times corporations take foreign tax credits that exceed the U.S. taxes that would apply to the foreign income. To limit the use of foreign tax credits to reduce U.S. taxes on U.S. profits, the President proposes to close these loopholes.

#### *Crack Down on Offshore Tax Evasion.*

The President proposes several measures to step up withholding taxes collected by U.S. financial institutions that make transfers to foreign financial institutions that do not agree to meet certain information standards, to require increased reporting from foreign banks that do enter into such agreements with the U.S. and to adopt several other measures to make it easier for the IRS to locate funds that Americans shift to offshore bank-secrecy (tax-haven) jurisdictions to evade U.S. taxes.

## **Repeal LIFO Inventory Accounting Rules**

### **Ten-Year Revenue Gain: \$61.1 Billion**

The President's budget includes a proposal to repeal the "last-in, first-out" (LIFO) method of accounting for inventories. This accounting method allows companies to deduct the higher cost of recently acquired or produced inventory, rather than the lower cost of older inventory.

For example, we normally think of profit this way: You buy something for \$30 and sell it for \$50 and your profit is \$20 (ignoring any other expenses). But corporations, notably oil companies, use an accounting method that doesn't fit this picture. They might buy oil for \$30 a barrel, and when the price rises they might buy some more for \$45 a barrel. But when they sell a barrel of oil for \$50, they get to assume that they sold the very last barrel they bought, the one that cost \$45. That means the profit they report to the IRS is \$5 instead of \$20. This "last-in, first-out" rule (LIFO) has been in place for decades, and critics have long called for its repeal. In 2005, the then-Republican-led Senate tried to repeal it for oil and gas companies. (The provision was dropped from the tax bill in conference, so oil companies still get to use LIFO.)

Repealing LIFO would greatly simplify the tax rules related to accounting for inventories. This provision, which would not be effective until 2012, would raise \$61.1 billion over eight years.

## **Eliminate Oil and Gas Company Tax Breaks**

### **Ten-Year Revenue Gain: \$31.5 Billion**

The budget proposal takes aim at several tax provisions that benefit only the oil and gas industry. Repealing these special rules — subsidies to the industry paid for by everyone else — would raise \$31.5 billion over ten years. Here are a few of the largest (in terms of revenue impact) tax breaks for oil and gas that the President proposes to eliminate.

#### *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. In effect, a company's taxable income (which has already been reduced by all of its expenses) is reduced by another 9 percent if all of the company's income is from domestic manufacturing. Some might wonder why oil and gas companies could use a deduction for "manufacturing" in the first place. 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 Percentage Depletion for Oil and Natural Gas.*

Most businesses must write off the actual costs of property over its useful life (until it wears 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 — 15 percent in the case of oil and 22 percent in the case of natural gas. The percentage depletion deductions continue even after all of the costs of the property have been written off.

#### *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.

## **Modify Estate and Gift Taxes**

### **Ten-Year Revenue Gain: \$24.2 Billion**

#### *Consistent Valuation Rules.*

When property is inherited, the recipient has a “basis” in that property, which is the value used to determine whether the recipient has a gain or loss if that property is sold in the future. The basis for inherited property is the fair market value of the property at the time of decedent’s death. The same rule applies for determining estate taxes, since the value of assets for estate tax purposes is also the fair market value at the time of the decedent’s death.

But sometimes executors of estates and heirs find ways of defining “fair market value” quite differently. In other words, sometimes the executor of an estate uses a lower value for estate tax purposes than the heirs use for the purpose of determining their basis in the property they inherit. The President’s proposal would require the same value to be used for determining gift and estate taxes and for determining basis for heirs, and would require that basis information be reported to the recipient and the IRS.

#### *Limiting Valuation Discounts.*

Wealthy people sometimes transfer to their children a small part of a family-owned business with restrictions on the children’s ability to sell or control that business. Even though these “restrictions” are often ignored or removed later, families claim that they reduce the value of the gift for purposes of calculating the gift or estate tax. The President’s proposal would essentially have the IRS ignore some of the meaningless “restrictions” in these transfers, which will result in a higher value for gift and estate tax purposes.

#### *Minimum Term for GRATs.*

A person owning an asset with a quickly rising value may want to find some way to “lock in” its current value for purposes of calculating estate and gift taxes before it rises any further. One way is to place the asset in a certain type of trust (a Grantor Retained Annuity Trust, or GRAT) that pays an annuity for a certain time and then leaves whatever assets remain to the trust’s beneficiaries. The gift to the trust’s beneficiaries is valued when the trust is set up, rather than when it’s received by the beneficiaries. This benefit is particularly difficult to justify when the trust has a very short term (perhaps just a couple years) and wealthy people have used such short-term trusts to aggressively reduce or even eliminate any tax on gifts to their children. The President’s proposal would require a GRAT to have a minimum term of 10 years, increasing the chance that the grantor will die during the GRAT’s term and the assets will be included in the grantor’s estate.

## **Close the “Carried Interest” Loophole**

### **Ten-Year Revenue Gain: \$23.5 Billion**

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 are paying capital gains taxes of 15 percent on their compensation instead of the ordinary income tax rates (up to 35 percent) that the rest of us pay.

Income in the form of carried interest can run into the hundreds of millions of dollars a year for individual fund managers. Carried interest income is clearly compensation for work, rather than

capital gains, because the managers do not invest their own money. Rather, carried interest is like other performance-based compensation (like stock options) paid to corporate executives and which is subject to income taxes at regular rates and payroll taxes.

In other words, private equity fund managers are benefiting from a tax break that is meant to subsidize investment even though they don't invest.

The administration projects that it can save \$23.5 billion over a decade by closing the loophole that allows carried interest to be taxed as capital gains instead of ordinary income.

### **Reinstate Superfund Taxes**

#### **Ten-Year Revenue Gain: \$23.5 Billion**

In 1980, Congress passed legislation (the Comprehensive Environmental Response, Compensation, and Liability Act, known as "CERCLA" or more commonly, the "Superfund") to provide broad federal authority to clean up hazardous substances that may endanger public health or the environment. The program was funded by three Superfund taxes: a petroleum tax, a hazardous chemicals tax, and a corporate environmental income tax (0.12% on corporate profits over \$2 million). The taxes expired in 1995, and the fund was depleted in 2003. Since that time, clean up has been funded out of the general revenues of the federal government. The President's budget would reinstate the Superfund Taxes.

### **Close Loopholes for Insurance Companies**

#### **Ten-Year Revenue Gain: \$12.7 Billion**

The President's budget proposal would require the reporting of purchases of life insurance policies of over \$1 million to prevent tax evasion. It would also restrict techniques used by life insurance companies to fund tax-deductible reserves with non-taxable income.