Citizens for Tax Justice

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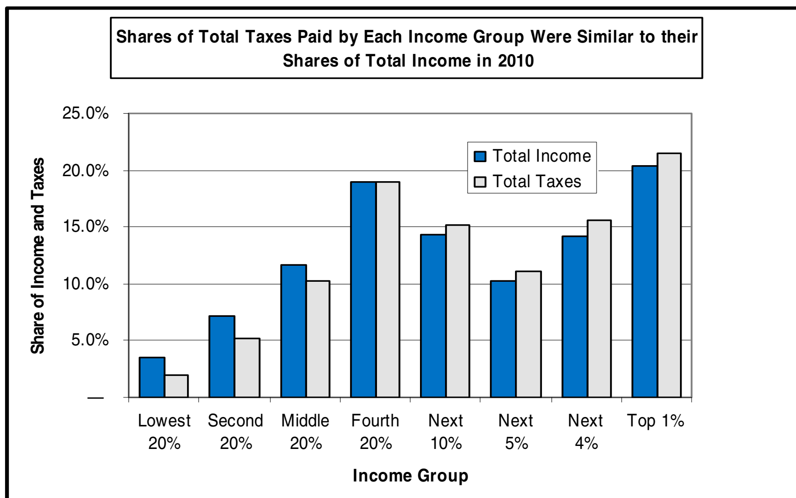
Policy Options to Raise Revenue by Eliminating or Reducing Tax Subsidies for Wealthy Individuals and Profitable Businesses

Congress has several options for raising revenue by reducing or eliminating regressive tax subsidies that benefit profitable businesses and wealthy investors.

This report describes several of these options, and includes revenue estimates from the non-partisan Joint Committee on Taxation (JCT) and Congressional Budget Office (CBO). These estimates were produced to project the revenue effects of actual legislative changes and therefore accurately describe the revenue that can be saved from reducing or eliminating tax subsidies.[1]



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America is one of the least taxed countries in the developed world.[2] The tax system we have is just barely progressive, meaning it does very little to address the growing income inequality experienced over the last several decades.[3] The share of total taxes paid by each income group is very similar to the share of total income received by that group.

For example, the share of total taxes (including federal, state and local taxes) paid by the richest one percent (21.5%) is not significantly different from the share of total income received by this group (20.3%). Similarly, the share of total taxes paid by the poorest fifth (2.0%) is only slightly lower than the share of total income received by this group (3.5%).

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[1] JCT also publishes tax expenditure reports which describe the revenue foregone as a result of each tax subsidy, but in some cases this may be different from the amount of revenue that would be raised from actual legislation that eliminates these tax subsidies (because of behavioral responses to tax changes and other factors). The figures cited in this report are revenue estimates of actual policy changes, describing how much revenue would be raised by such legislation.

[2] During the most recent year for which OECD data are available, the United States collected lower taxes as a share of GDP than all but two OECD countries, Chile and Mexico. See Citizens for Tax Justice, "U.S. Is One of the Least Taxed Developed Countries," June 30, 2011. http://www.ctj.org/pdf/oecd201106.pdf

[3] The figures presented in the following paragraph and nearby table and graph first appeared in Citizens for Tax Justice, "America's Tax System Is Not as Progressive as You Think," April 15. http://www.ctj.org/pdf/taxday2011.pdf

Many of the tax loopholes described below allow some among the richest 1 percent to pay even less than middle-income families. This is particularly troubling given that the wealthiest Americans arguably benefit the most from the services that taxes make possible, including the roads that facilitate commerce, the public education that creates a productive workforce, the defense and policing that provides stability and protection of private property necessary for businesses to thrive.

Lawmakers may prefer to adopt the following policy options as part of a comprehensive tax reform of the personal income tax, the corporate income tax, or both. Some lawmakers have discussed a reform of the personal income tax or corporate income tax that would be "revenue-neutral," meaning loopholes would be reduced or eliminated but the resulting revenue savings would be used entirely to pay for reduction in tax rates.

America needs reforms that are "revenue-positive." Given the current budget concerns and the threats to health care, education, nutrition and other public services, any such tax reform should result in increased revenue. In other words, if Congress decides to reduce or eliminate tax loopholes, most if not all of the resulting revenue savings should be used to reduce the deficit or pay for public investments rather than used to pay for a reduction in tax rates.

Incomes and Federal, State & Local Taxes in 2010

		Shares of		Taxes as a % of Income		
	Average cash income	Total income	Total taxes	Federal taxes	State & local taxes	Total taxes
Lowest 20%	$ 12,500	3.5%	2.0%	3.9%	12.3%	**16.2%**
Second 20%	25,300	7.1%	5.2%	9.1%	11.6%	**20.7%**
Middle 20%	40,700	11.6%	10.3%	13.9%	11.2%	**25.1%**
Fourth 20%	66,300	19.0%	19.0%	17.3%	11.1%	**28.5%**
Next 10%	100,000	14.3%	15.1%	19.0%	11.0%	**30.0%**
Next 5%	140,000	10.2%	11.2%	20.5%	10.6%	**31.1%**
Next 4%	241,000	14.2%	15.6%	21.4%	9.9%	**31.3%**
Top 1%	1,254,000	20.3%	21.5%	22.1%	7.9%	**30.0%**
ALL	**68,200**	**100.0%**	**100.0%**	**18.1%**	**10.3%**	**28.4%**
Addendum: Bottom 99%	$ 56,200	79.8%	78.4%	16.9%	10.9%	**27.9%**

Notes:
1. Taxes include all federal, state & local taxes (personal and corporate income, payroll, property, sales, excise, estate etc.).
2. For calculations of income shares and taxes as a % of income, income includes employer-paid FICA taxes and corporate profits net of taxable dividends, neither of which is included in the average cash income figures shown.

Source: Institute on Taxation and Economic Policy Tax Model, April 2011

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Reduce or eliminate the tax preferences for capital gains.
10-year revenue impact: +$48.5 billion for two percentage point rate increase[4]

The federal income tax currently taxes the income of people who live off their wealth at lower rates than the income of people who work. The tax cuts first enacted under President George W. Bush increased this tax preference. This is particularly problematic because income from wealth (investment income) is largely concentrated among the richest Americans.

The unfairness of the existing preferences for capital gains and dividends can best be illustrated with an example. Imagine an heiress owns so much stock and other assets that she does not have to work. She receives stock dividends, and when she sells assets (through her broker, of course) for more than their original purchase price, she enjoys the profit, which is called a capital gain. On these two types of income, she only pays a tax rate of 15 percent.

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[4] Congressional Budget Office (CBO), "Reducing the Deficit: Spending and Revenue Options," March 2011, p. 142. http://www.cbo.gov/doc.cfm?index=12085 The option studied by CBO would raise the capital gains rates by 2 percentage points and raise 48.5 billion from 2012 through 2021. It is likely that any options considered in this report would go into effect in 2013 and therefore raise slightly more revenue during the decade that follows.

Now consider a receptionist who works at the brokerage firm that handles some of the heiress's dealings. Let's say this receptionist earns $50,000 a year. Unlike the heiress, his income comes in the form of wages, because, alas, he has to work for a living. His wages are taxed at progressive rates, and a portion of his income is actually taxed at 25 percent. (In other words, he faces a marginal rate of 25 percent, meaning each additional dollar he earns is taxed at that amount).

On top of that, he also pays the federal payroll tax of around 15 percent. (He pays only half of the payroll tax directly and his employer directly pays the other half, but economists generally agree that it's all ultimately borne by the employee in the form or reduced compensation.) So he pays taxes on his income at a higher rate than the heiress who lives off her wealth.

What make this situation even worse are the various loopholes that allow wealthy individuals to receive these tax breaks for income that is not really even capital gains or dividends. As Warren Buffett has explained, fund managers use the "carried interest" loophole to have their compensation treated as capital gains and taxed at the low 15 percent rate, while the "60/40 rule" benefits traders who "own stock index futures for 10 minutes and have 60 percent of their gain taxed at 15 percent, as if they'd been long-term investors."[5]

The tax reform signed into law by President Reagan in 1986 eliminated such preferences for investment income and taxed all income at the same rates. During the administrations of George H.W. Bush and Bill Clinton the rates on "ordinary" income (income that does not take the form of long-term capital gains) were raised and the rates for capital gains were reduced near the end of the Clinton administration.

When George W. Bush took office, the top tax rate on long-term capital gains was 20 percent, and the tax changes he signed into law in 2003 reduced that the top rate to 15 percent. The same law also applied the lower capital gains rates to corporate stock dividends, which before then were taxed as ordinary income. If the Bush tax cuts, which were recently extended through 2012, are allowed to expire, then capital gains will again be taxed at a top rate of 20 percent (meaning there will still be a tax preference, albeit a reduced one, for capital gains) and stock dividends will be taxed like any other income.

The Congressional Budget Office (CBO) recently estimated that increasing the capital gains rates by just two percentage points would yield about $49 billion in revenue over a decade.[6] Congress could

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[5] Warren E. Buffett, "Stop Coddling the Super-Rich," *New York Times* op-ed, August 14, 2011. http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html?_r=1&scp=1

[6] There is some controversy about whether or not the same amount of revenue would be raised for each incremental increase in the rates. Some commentators like the editorial board of the Wall Street Journal (and to a lesser extent, Congress's Joint Committee on Taxation) believe that if the rate for capital gains reaches a certain point, investors will respond by selling assets less often and the revenue yield from the tax will be reduced as a result. These behavioral effects are exaggerated. Revenue collected from taxing capital gains was higher during the Clinton years when the rate was higher than in years after 2003 when the rate was reduced under President Bush. (See Citizens for Tax Justice, "Time to Stop Subsidizing Wall Street: Eliminate the Tax Loopholes for Capital Gains and Dividends," October 1, 2008. http://www.ctj.org/pdf/endcgdivloopholes.pdf) Also, claims that the 1986 tax reform caused a drop-off in capital gains tax revenue fail to mention that there was an increase in capital gains tax revenue leading up to the reform going into effect, as individuals rushed to cash in assets before their tax preferences disappeared, and then afterwards such sales naturally dropped off from this artificial high point.

go much further by reforming the tax system so as to completely eliminate any preference for capital gains. The estimates in the nearby table show that over four fifths of the tax increase resulting from eliminating the capital gains preference in 2013 would be paid by the richest one percent of taxpayers.

Taxing Capital Gains as Ordinary Income
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	1.2%	$ 1	0.0%	0.0%
Second 20%	28,157	3.6%	2	0.0%	0.1%
Middle 20%	45,225	7.5%	6	0.0%	0.4%
Fourth 20%	74,252	17.2%	30	0.0%	1.8%
Next 15%	128,389	32.9%	131	0.1%	5.9%
Next 4%	275,151	55.9%	828	0.3%	10.0%
Top 1%	1,472,933	70.5%	27,039	1.8%	81.7%
ALL	$ 76,142	13.6%	$ 326	0.4%	100.0%

Citizens for Tax Justice, September 2011

Eliminate depreciation breaks in the personal and corporate income taxes.
10-year revenue impact: +$568.6 billion[7]

Businesses are allowed to deduct from their taxable income the expenses of running the business, so that what's taxed is profit. Businesses can also deduct the costs of capital purchases, but since capital investments don't lose value right away, these deductions are taken over time. The basic idea behind depreciation is that when a company makes a capital purchase of a piece of equipment, they can deduct the cost of that equipment over the period of time in which the equipment is thought to wear out.

Accelerated depreciation allows a company to take these deductions more quickly — sometimes far more quickly — than the equipment actually wears out. The deductions for the cost of the capital purchase are thus taken earlier, which makes them more valuable. Accelerated depreciation was introduced during the 1970s and was so generous that many large corporations were able to avoid taxes entirely. This resulted in a public outcry that led to the Tax Reform Act of 1986, which curtailed, but did not eliminate, accelerated depreciation.

Combined with rules allowing corporations to deduct interest expenses, accelerated depreciation can result in a very low, or even negative, tax rate on profits from a particular investment. A corporation could borrow money to purchase equipment or a building, deduct the interest expenses on the debt and quickly deduct the cost of the equipment or building thanks to accelerated depreciation. The total deductions can then be more than the profits generated by the investment. Worst of all, accelerated depreciation does not even accomplish the goal of increasing investment. [8]

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[7] Joint Committee on Taxation (JCT), "Estimated Revenue of S.308, "The Bipartisan Tax Fairness and Simplification Act of 2010," November 2, 2010. http://wyden.senate.gov/imo/media/doc/Score.pdf JCT estimated the effects of the provisions in Senator Ron Wyden's tax bill assuming that they came into effect in 2011. It is likely that options considered in this report would go into effect in 2013 and therefore raise somewhat more revenue in the decade that follows.

[8] For example, while companies paid considerably more in taxes after the 1986 Tax Reform Act reduced tax breaks for business investments, business investment nonetheless flourished. To the chagrin of the supply-side advocates of corporate tax loopholes, real business investment grew by 2.7% a year from 1986 to 1989. That was 43 percent faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually falling at a 2% annual rate from 1981 to 1986. As former Reagan Treasury official, J. Gregory Ballentine, told *Business Week*: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]." Conversely, legislation enacted in 2002 and 2003 expanding write-offs for accelerated depreciation failed

The Joint Committee on Taxation (JCT), the official revenue estimator for Congress, projects that the provision in Senator Ron Wyden's tax reform bill to repeal accelerated depreciation would raise almost $570 billion over a decade.

Repeal the rule allowing U.S. corporations to "defer" U.S. taxes on their offshore profits.
10-year revenue impact: +$582.7 billion[9]

U.S. corporations are allowed to defer paying taxes on the profits of their offshore subsidiaries until those profits are brought to the U.S. (repatriated).[10] For example, a U.S. corporation might have a wholly owned subsidiary corporation in another country. The U.S. corporation (the "parent" corporation) can "defer" U.S. taxes on the profits generated by the offshore subsidiary until they are repatriated. (Typically, repatriation would take the form of a dividend paid by the subsidiary to the U.S. parent corporation.)

Deferral causes some major problems. The first problem is that deferral may give American corporations an incentive to move operations and jobs offshore. Because the U.S. does not tax profits generated offshore (unless the profits are repatriated), corporations could pay less in taxes by moving production to a country with lower corporate income taxes.

The second major problem is that deferral creates an incentive for American corporations to disguise their U.S. profits as "foreign" profits. They do this by engaging in transactions that shift their profits to subsidiaries in countries that tax the profits lightly or not at all (countries that serve as corporate tax havens). For example, a U.S. parent company may transfer a patent to its wholly owned subsidiary based in a tax haven (perhaps the Cayman Islands or Bermuda) and then tell the IRS that it has no profits because it had to pay huge fees to the subsidiary for the use of that patent. The subsidiary is thus claimed to have high profits — but the U.S. parent company can "defer" (not pay) taxes on those profits because they are (allegedly) generated abroad. The subsidiary in the tax haven may consist of little more than a post office box.

In theory, we have "transfer pricing" rules that are meant to limit this type of tax avoidance, but they work very poorly. Transfer pricing rules are meant to require divisions within a corporate group (like the U.S. parent company and its offshore subsidiary in our example) to deal with each other "at arm's length." In other words, they require the U.S. parent corporation and its subsidiary to pretend to deal with each other as if they were unrelated companies. If these rules worked, they would mean that the U.S. parent company would charge a fair market price to its foreign subsidiary for the patent it transfers, and the subsidiary would charge fees at market rates for the use of the patent. There would be little opportunity to artificially reduce the profits of the U.S. parent company.

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to increase investment by major corporations. CTJ's 2004 study of 275 profitable corporations found that in the aggregate, their total property, plant and equipment investments declined from 2001 to 2003 by 15 percent. Even more striking, such investments dropped by 27 percent for the 25 corporations with the largest depreciation breaks, meaning the companies getting the most benefits from accelerated depreciation actually reduced their investment more than others. See Robert S. McIntyre & T.D. Coo Nguyen, *Corporate Income Taxes in the Bush Years*, Citizens for Tax Justice, September 2004. http://www.ctj.org/corpfed04an.pdf

[9] JCT, 2010.

[10] Deferral is not necessary to avoid profits being taxed multiple times because a U.S. corporation (or any U.S. taxpayer for that matter) takes a credit for any taxes paid to a foreign government. (This is the "foreign tax credit.")

But this is not what really happens. It's often difficult or impossible for the IRS to prove that a transaction between two divisions of a corporate group were not conducted at arm's length. This requires the IRS to find and present comparable transactions that are conducted between unrelated parties. Sometimes there simply are no comparable transactions to those conducted between divisions within a corporate group, particularly those regarding intellectual property.

Another problem with deferral is that some of the expenses a corporation incurs to earn offshore profits are deductible against their U.S. taxable income right away, even though the offshore profits are not taxed until they are repatriated (which may never happen). Allowing immediate deductions of these expenses is, at best, a tax subsidy for moving operations offshore. Even worse, it makes corporations even more tempted to devise schemes to make it appear that their U.S. income is being earned offshore.

If deferral was repealed, corporations would have little or no tax incentive to move jobs offshore or to shift profits offshore using shady transactions involving tax havens, because the U.S. would tax profits of American corporations no matter where they are generated.

American corporations would continue to get a credit against their U.S. taxes for foreign taxes they pay. That means that when an American corporation has profits in a country with a lower corporate tax rate than ours, they would pay to the U.S. government just the difference between the foreign rate and the U.S. rate. When an American corporation has profits in a country with a higher corporate tax rate than ours, they would pay nothing to the U.S. government. This is how the system works now, except that American corporations also can "defer" (not pay) the U.S. taxes entirely, and the combination of deferral and the foreign tax credit can create more opportunities for tax avoidance.[11]

Repeal deduction for domestic manufacturing.
10-year revenue impact: +$163.1 billion[12]

In 2002, the World Trade Organization (WTO) found that a particular tax break meant to support exports violated U.S. trade treaties with other countries. In the wake of this ruling, the European Union began imposing retaliatory sanctions against the United States in March of 2004. Congressional tax writers immediately sought to comply with the WTO ruling by repealing the illegal tax break. But lawmakers were wary of being seen as hiking taxes on manufacturers—even when the "tax hike" in question resulted from repealing an illegal tax break—and sought to enact new tax cuts that would offset the lost illegal subsidy for manufacturers. However, as the tax bill took shape, this provision was hijacked by legislators seeking to use the tax bill to provide new tax breaks for other favored corporations.

As finally enacted, the "manufacturing deduction" ballooned to apply to a wide variety of corporate activities that no ordinary person would recognize as "manufacturing," the most egregious of which

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[11] For more details on deferral and why it should be repealed, see Citizens for Tax Justice, "Congress Should End 'Deferral' Rather than Adopt a 'Territorial' Tax System," March 23, 2011.
http://www.ctj.org/pdf/internationalcorptax2011.pdf
[12] CBO, 2011, p. 182.

is oil drilling. The President has proposed to prohibit oil and gas companies from using the break, but Congress should go much farther and repeal the manufacturing deduction altogether. It provides no identifiable benefit to the economy and repealing it altogether could raise $163 billion over a decade.[13] (President Obama's proposal to bar oil and gas companies from using it would raise only $15.9 billion over a decade according to JCT.)[14]

Repeal first-in, last-out (LIFO) accounting.
10-year revenue impact: +$97.5 billion[15]

The "last-in, first-out" or LIFO, inventory rule allows companies to manipulate their inventory accounting to make their profits appear smaller than they actually are. LIFO 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.) The Obama administration has, reasonably, proposed repeal of LIFO.

[13] Repeal of the manufacturing deduction would also greatly help several state governments (many of which are facing dire budget crises). This is because many states have corporate income taxes that are linked to the federal corporate income tax, so a deduction on the federal level applies on the state level as well. State lawmakers can enact legislation to "decouple" from the federal rules related to this deduction. But political and constitutional constraints in some states make it difficult to enact any sort of "tax increase," even when it only consists of decoupling from federal rules allowing a deduction. See Institute on Taxation and Economic Policy, "The QPAI Corporate Tax Break: How It Works and How States Can Respond," October 2008. http://www.itepnet.org/pb33qpai.pdf

[14] Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal," March 17, 2011. http://www.jct.gov/publications.html?func=startdown&id=3773

[15] CBO, 2011, p. 177.