Citizens for Tax Justice

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Policy Options to Raise Revenue

Congress has many options to raise revenue by closing tax loopholes and reducing tax subsidies. All federal taxes — the personal income tax, corporate income tax, payroll taxes, estate and gift taxes — are shot through with such tax breaks, many of which do more harm than good.

Part I of this report summarizes how and why Congress should raise revenue by eliminating tax loopholes and tax subsidies. Part II of this report explains eleven specific options to do this in detail and how much revenue could be raised from each. This information is summarized in the table to the right.

Policy Options to Raise Revenue

Policy Option	10-Year Revenue Impact ($billions)
Repeal Capital Gains Break Tax capital gains at same rates as other income under the personal income tax.	$533*
Repeal "Deferral" End rule allowing U.S. corporations to "defer" U.S. taxes on offshore profits.	$583
Eliminate Accelerated Depreciation End rules in corporate and personal income taxes allowing deductions for investments faster than assets wear out.	$569**
Repeal Domestic Manufacturing Deduction End section 199 deduction that is ostensibly to encourage manufacturing in the U.S.	$163
Enact Buffett Rule Senator Whitehouse's legislation to require millionaires to pay at least 30 percent of income in federal taxes.	$171
Repeal LIFO & LCM Bar "last-in, first-out," and "lower cost or market" methods of manipulating inventory accounting.	$98
Bank Fee Enact Obama's proposed fee on riskier assets of the largest banks.	$61
Repeal Fossil Fuel Tax Subsidies Repeal deduction for "intangible" drilling costs, percentage depletion, amortizing oil search costs, and breaks for "dual capacity" taxpayers.	$38
Close Stock Options Loophole Close the loophole allowing corporations to deduct more for tax purposes for stock options than they report to shareholders.	$25
Close Carried Interest Loophole Require compensation paid to fund managers to be taxed at same rates as other income from work rather than capital gains rates.	$21
Close Payroll Tax Loophole for S Corporations Close loophole used by Newt Gingrich and John Edwards to characterize earned income as unearned to avoid Medicare tax.	$11

*At least $533 billion, depending on behavioral effects. See appendix.
**Ending depreciation breaks would raise less revenue after this decade.

I. How and Why Congress Should Raise Revenue by Closing Tax Loopholes

Closing Tax Loopholes Can Be Part of a Major Tax Reform or a Small Initiative

Even when lawmakers agree that the tax system has too many loopholes, they cannot agree on how to get rid of them. Some lawmakers oppose legislative proposals that would close one or two small tax loopholes and say that such changes should be done as part of a sweeping tax reform that overhauls the entire tax code. Other oppose sweeping tax reform as too radical a change and prefer to focus on the more limited proposals to close one or two small tax loopholes.

The table at the right includes options that are compatible with either approach. Some of the revenue-raisers suggested here are so large that they are most likely to be enacted as part of a sweeping tax reform or some other major initiative. Others are relatively small and might be used to, for example, offset the costs of a temporary increase in infrastructure spending, food stamps, unemployment insurance or some other economic recovery measure.

For example, Congress could raise at least $533 billion over ten years by closing an enormous loophole in the personal income tax for capital gains income. This tax break allows wealthy investors like Warren Buffett to pay taxes at lower effective rates than many middle-class people. Or Congress could raise just $21 billion by closing a smaller loophole allowing certain wealthy fund managers like Mitt Romney to characterize the "carried interest" they earn as "capital gains."

Similarly, Congress could raise $583 billion over ten years by closing the huge loophole in the corporate income tax allowing U.S. corporations to indefinitely "defer" paying U.S. taxes on profits that they generate offshore or that appear to be generated offshore because of dodgy accounting methods. Or Congress could raise $25 billion by closing a loophole that allows corporations to deduct more for tax purposes for the stock options they pay their executives (like Facebook's Mark Zuckerberg) than they report as an expense to their shareholders.

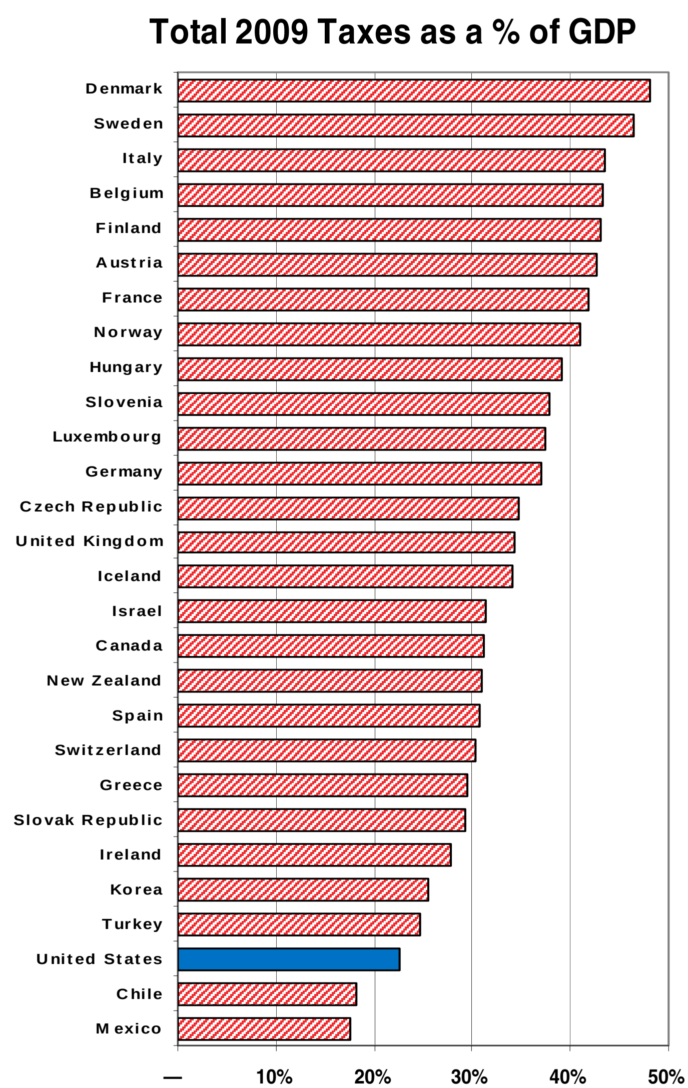
Or Congress could turn to loopholes in the payroll taxes that fund Social Security and Medicare. Lawmakers could raise $11 billion over ten years by closing a loophole used by Newt Gingrich and John Edwards to characterize some of their earned income as unearned income in order to avoid payroll taxes.

These are just a few examples among many that are described in more detail in this report.

Tax Loopholes Provide Subsidies that Are Not Always Necessary or Helpful

Tax subsidies are like other government programs that favor particular activities, individuals or companies, except that they are provided through the tax code instead of through direct payments. The effect is the same. A check for a billion dollars from the government to, say, an oil company, has the same effect as a tax deduction that reduces the oil company's taxes by a billion dollars.

The only real difference is that once a tax subsidy is enacted (particularly one that is permanent, as most are), lawmakers tend to completely ignore their costs even as they insist that direct spending programs are unaffordable.



Source: Organization for Economic Cooperation and Development (OECD)

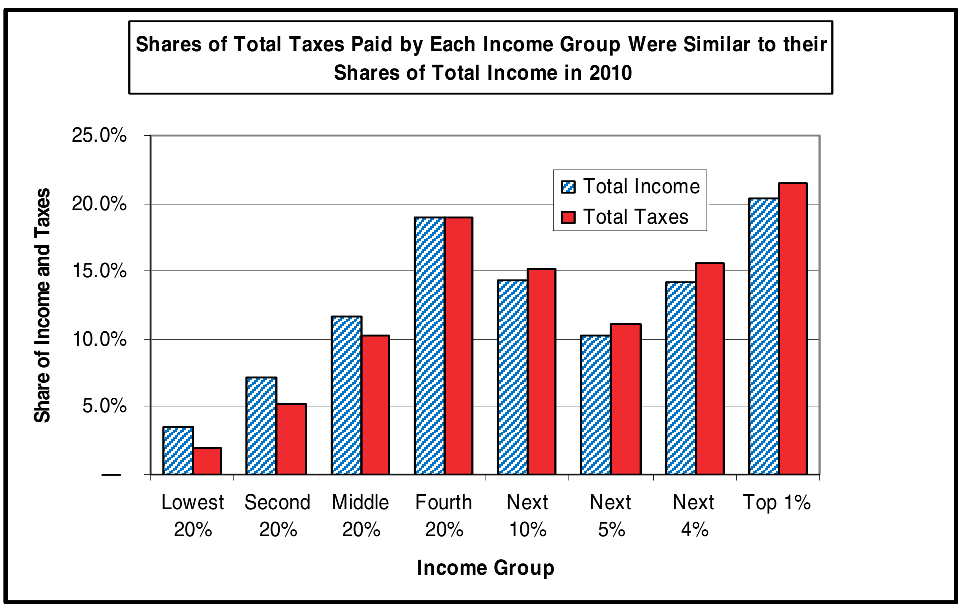
Most of the reforms listed here would end a subsidy by closing a tax loophole in a straightforward way. One reform, the "Buffett Rule," is a roundabout way of limiting the capital gains tax preference for millionaires (albeit one not nearly as effective as repealing that loophole entirely). Another, the bank fee proposed by President Obama, is a way to get the largest financial institutions to pay for the subsidy they receive in the implicit guarantee that the government will rescue banks that are "too big to fail."

Tax Subsidies Leave Less Revenue to Invest in Other Priorities

It makes little sense for lawmakers to leave in place tax subsidies that benefit those who least need them while lawmakers debate cuts in public investments that build the American middle-class. Revenue saved from closing loopholes could be used to hire teachers, repair infrastructure, expand health care, improve nutrition, and make early education and child care affordable for working families. These investments are far more likely to create jobs than the loophole allowing Newt Gingrich and John Edwards to avoid payroll taxes, or the loophole allowing Warren Buffett to pay a lower effective tax rate than his secretary, or the loophole allowing Facebook to deduct billions for stock options given to its CEO Mark Zuckerberg.

America Is Not Overtaxed

The belief that Americans pay too much, rather than too little, in taxes has so permeated our society that Microsoft Word's spellchecker recognizes the word "overtaxed" but not its obvious antonym, "undertaxed." As a result of this belief, some anti-government activists and politicians insist that no tax loopholes should be closed unless tax rates are also reduced so that the net result is no increase in revenue collected by the federal government. This approach is entirely unwarranted, because America is actually one of the least taxed countries in the developed world. According to the Organization for Economic Cooperation and Development (OECD), the U.S. collects less tax revenue, as a percentage of gross domestic product, than all but two other industrial countries (Chile and Mexico), as illustrated on the previous page.[1]



Citizens for Tax Justice, April 2011

Wealthy Individuals Are Not Overtaxed

Another anti-tax argument is that the richest one percent or richest five percent of Americans are already paying more than their fair share of taxes, but this is also false. America's tax system is just barely progressive, meaning it does very little to address

[1] 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

the growing income inequality our nation has experienced over the last several decades.[2] The share of total taxes paid by each income group is very similar to the share of total income received by each group.

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

Corporations Are Not Overtaxed

Some corporate lobbyists complain that the U.S. statutory corporate income tax rate of 35 percent is one of the highest in the word. They fail to mention that the *effective* corporate income tax rate, the percentage of profits that corporations actually pay, is far lower because of the loopholes that reduce their taxes. In fact, some corporate profits are not taxed at all. A recent report from CTJ examined 280 corporations (most of the Fortune 500 companies that were profitable for each of the three years from 2008 through 2010) and found that 30 of them paid no federal corporate income taxes over the three-year period. Seventy-eight of the companies had at least one no-tax year during that period. The average effective tax rate for the 280 companies was only 18.5 percent over the three-year period.[3]

30 Corporations Paying No Total Income Tax in 2008-2010

Company ($-millions)	08-10 Profit	08-10 Tax	08-10 Rate
Pepco Holdings	$ 882	$ –508	–57.6%
General Electric	10,460	–4,737	–45.3%
Paccar	365	–112	–30.5%
PG&E Corp.	4,855	–1,027	–21.2%
Computer Sciences	1,666	–305	–18.3%
NiSource	1,385	–227	–16.4%
CenterPoint Energy	1,931	–284	–14.7%
Tenet Healthcare	415	–48	–11.6%
Atmos Energy	897	–104	–11.6%
Integrys Energy Group	818	–92	–11.3%
American Electric Power	5,899	–545	–9.2%
Con-way	286	–26	–9.1%
Ryder System	627	–46	–7.3%
Baxter International	926	–66	–7.1%
Wisconsin Energy	1,725	–85	–4.9%
Duke Energy	5,475	–216	–3.9%
DuPont	2,124	–72	–3.4%
Consolidated Edison	4,263	–127	–3.0%
Verizon Communications	32,518	–951	–2.9%
Interpublic Group	571	–15	–2.6%
CMS Energy	1,292	–29	–2.2%
NextEra Energy	6,403	–139	–2.2%
Navistar International	896	–18	–2.0%
Boeing	9,735	–178	–1.8%
Wells Fargo	49,370	–681	–1.4%
El Paso	4,105	–41	–1.0%
Mattel	1,020	–9	–0.9%
Honeywell International	4,903	–34	–0.7%
DTE Energy	2,551	–17	–0.7%
Corning	1,977	–4	–0.2%
TOTAL	$ 160,341	$ –10,742	–6.7%

Of course, corporate income taxes are ultimately borne by human beings — the corporate shareholders and owners of business assets, who are concentrated among the wealthiest Americans.[4] As already explained, the richest Americans are not overtaxed, even when you account for all of the taxes, including corporate income taxes, that they ultimately pay.

Below are eleven examples of the many reforms Congress could pursue to close loopholes and ensure that wealthy individuals and profitable corporations pay their fair share of taxes. They are summarized in the table on page one.

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[2] The figures presented in the following paragraph and nearby 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

[3] Citizens for Tax Justice, "Corporate Taxpayers & Corporate Tax Dodgers, 2008-2010," November 3, 2011. http://ctj.org/corporatetaxdodgers/

[4] Citizens for Tax Justice, "Fact Sheet: Why Congress Can and Should Raise Revenue through Corporate Tax Reform," November 3, 2011. http://ctj.org/pdf/corporatefactsheet.pdf

II. Specific Options to Raise Revenue

Eliminate the tax preferences for capital gains.
10-year revenue impact: at least +$533 billion[5]

The federal personal 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 bias against work. 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 who 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) for more than their original purchase price, she enjoys the profit, which is called a capital gain. (Most of these gains are "long-term" capital gains, which we often refer to as "capital gains" for simplicity.) On these two types of income, stock dividends and long-term capital gains, she pays a tax rate of only 15 percent.

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 income tax 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, while his employer directly pays the other half, but economists generally agree that the full tax is ultimately borne by the employee in the form of reduced compensation.) So he pays taxes on his income at a higher rate than the heiress who lives off her wealth.

Impact of Taxing Long-Term Capital Gains as Ordinary Income in 2014

Income Group	Average Income	Total Tax Change ($billions)	Average Tax Change	Percent with Tax Increase	Share of Tax Increase
Lowest 20%	$ 14,597	$ 0.0	$ 1	1%	0%
Second 20%	29,474	0.1	3	4%	0%
Middle 20%	47,333	0.2	7	8%	0%
Fourth 20%	78,084	1.0	33	17%	2%
Next 15%	135,574	3.2	145	33%	7%
Next 4%	293,500	4.8	825	57%	10%
Top 1%	1,634,204	37.4	25,507	72%	80%
ALL	$ 81,089	$ 46.7	$ 314	14%	100%

Note: This proposal would raise at least $46.7 billion in 2014, depending on behavioral effects. See appendix.
Source: Institute on Taxation and Economic Policy (ITEP), March 2012.

What makes 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."[6]

[5] Institute on Taxation and Economic Policy (ITEP) microsimulation tax model, March 2012.
[6] 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

The tax reform signed into law by President Reagan in 1986 eliminated such preferences for investment income from the personal income tax 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, but the rates for capital gains were reduced in 1997.

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 top rate to 15 percent. The same law also applied the lower capital gains rates to corporate stock dividends, which previously were taxed as ordinary income. If the Bush tax cuts, which were extended through 2012, are allowed to expire, then capital gains will again be taxed at a top income-tax rate of 20 percent (meaning there will still be a tax preference for capital gains) and stock dividends will once again be taxed like any other income.

By allowing the Bush tax cuts for capital gains and dividends to expire at the end of 2012, Congress would avoid further reducing revenue in a way that mainly helps wealthy investors.

In addition, Congress should repeal the capital gains break that will still exist (the special rates not exceeding 20 percent). Under this proposal, capital gains would simply be taxed at ordinary income tax rates. This would raise at least $533 billion over a decade.[7] The table on the previous page shows that 80 percent of the tax increase resulting from eliminating the capital gains preference in 2014 would be paid by the richest one percent of taxpayers.

Some commentators, including The Wall Street Journal editorial board and many anti-tax activists, claim that if the income tax 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. They often claim that these behavioral responses are so strong that tax revenue will actually *decrease* if the tax rate for capital gains is raised, and revenue will actually *increase* if the tax rate is reduced.[8]

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) also assume that this behavioral response exists, to a lesser but still significant degree. It is likely that if JCT estimated the revenue impact of eliminating the income tax preferences for capital gains, they would assume that these behavioral responses limit the amount of revenue raised to a much smaller figure than we calculate.[9]

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[7] Figures used here incorporate the assumptions of the Congressional Budget Office that capital gains income will decline in 2013, presumably in response to the end of the Bush tax cuts, and then quickly recover in years after that.

[8] These claims are easily refuted. 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.

[9] CBO and JCT have not examined the option of totally eliminating the income tax preference for capital gains but have analyzed a very small reduction in the preference. Congressional Budget Office, "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

We agree with the recent conclusion of the Congressional Research Service that JCT likely overestimates these behavioral responses and therefore underestimates how much revenue can be raised by raising income tax rates on capital gains.[10] It seems that people with investments do respond to changes in capital gains rates mostly in the short-term, but JCT relies on research that seems to mistake much of the short-term responses for long-term changes in investment behavior, as explained in the appendix at the end of this report.

The appendix also explains that we use JCT's methodology to quantify the way investors respond to tax changes, but we assume smaller behavioral responses based on rigorous studies cited and explained in detail by the Congressional Research Service.

Repeal the rule allowing U.S. corporations to "defer" U.S. taxes on their offshore profits.
10-year revenue impact: +$583 billion[11]

U.S. corporations are allowed to "defer" (delay) paying taxes on the profits of their offshore subsidiaries until those profits are brought back to the U.S. (repatriated).[12] 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.

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options considered in this report would go into effect in 2013 and therefore raise slightly more revenue during the decade that follows.

[10] Jane Gravelle, "Capital Gains Tax Options: Behavioral Responses and Revenue," Congressional Research Service, August 10, 2010.

[11] 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.

[12] 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.")

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.

But this is not what really happens. It's typically difficult or impossible for the IRS to prove that a transaction between two divisions of a corporate group was 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.

Even without deferral, 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 lower corporate taxes 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 higher corporate taxes 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.[13]

Eliminate accelerated depreciation in the personal and corporate income taxes.
10-year revenue impact: +$569 billion[14]

Businesses are allowed to deduct from their taxable income the expenses of running the business, so that what's taxed is net profit. Businesses can also deduct the costs of purchases of machinery, software, buildings and so forth, but since these capital investments don't lose value right away, these deductions are taken over time. The basic idea behind depreciation is that when a company

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[13] 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

[14] JCT, 2010. Note that this option would likely raise less revenue in years after the first decade because businesses would still be able to deduct the cost of capital expenditures, they would just do so over a longer number of years.

makes a capital purchase of a piece of equipment, it 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 bigger and more valuable. Accelerated depreciation was first introduced in the 1950s, and then greatly expanded in the 1970s and 1980s. The rules were 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, special tax breaks for capital purchases.

In recent years President George W. Bush and President Obama expanded depreciation breaks. In early 2008, in an attempt at economic stimulus for the flagging economy, Congress and President Bush created a supposedly temporary "50 percent bonus depreciation" provision that allowed companies to immediately write off as much as 75 percent of the cost of their investments in new equipment right away.[15] This provision was extended and expanded through 2012 under President Obama.

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 particular investments. A corporation can 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.[16]

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. It is important to note, however, that this option would likely raise less revenue in years after the first decade because businesses would still be able to deduct the cost of capital expenditures, they would just do so over a longer number of years.

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[15] Under "bonus depreciation," in the first full year that most equipment is placed in service, the depreciation write-offs include: a 20 percent regular write-off for the first half of the year, plus 50 percent bonus depreciation, plus a 6 percent write-off for the second half of the first full year.

[16] 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 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

Repeal deduction for domestic manufacturing.
10-year revenue impact: +$163 billion[17]

In 2002, the World Trade Organization (WTO) found that a U.S. tax break meant to encourage 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 moved 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 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.[18] The Treasury Department estimates that President Obama's proposal to bar oil and gas companies from using it would raise $11.6 billion over a decade. Unfortunately, the President proposes to use the revenue savings to *expand* the deduction for other companies.[19]

Enact the Buffett Rule.
10-year revenue impact: +$171 billion[20]

The "Buffett Rule" is the principle, proposed by President Obama, that the tax system should be reformed to reduce or eliminate situations in which millionaires pay lower effective tax rates than many middle-income people.

An earlier report from Citizens for Tax Justice explains how multi-millionaires like Mitt Romney and Warren Buffett who live on investment income can pay a lower effective tax rate than working class

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[17] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, p. 182. http://www.cbo.gov/doc.cfm?index=12085 This CBO study estimates the ten-year revenue impact of tax changes assuming they go into effect starting in 2012. It is likely that any option considered in this report would go into effect in 2013 and therefore raise slightly more revenue in the decade that follows.

[18] Repeal of the manufacturing deduction would also greatly help many state governments. 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

[19] Citizens for Tax Justice, "President Obama's 2013 Budget Plan Reduces Revenue by Trillions, Makes Permanent 78 Percent of Bush Tax Cuts," February 14, 2012. http://www.ctj.org/pdf/obamabudgetfy2013.pdf

[20] Institute on Taxation and Economic Policy (ITEP) microsimulation tax model, March 2012.

Millionaires with Investment Income Pay Lower Tax Rates than Many Middle-Income Taxpayers

Share of Middle-Income Taxpayers and High-Income Taxpayers Relying on Investment Income for a Portion of Total Reported Income, and Effective Combined Federal Income and Payroll Tax Rates, in 2011

Total Reported Income	$60k-$65k		$10 million or more	
	Share of Taxpayers Making $60k-$65k	Average Effective Tax Rate** for Taxpayers Making $60k-$65k	Share of Taxpayers Making $10 million +	Average Effective Tax Rate** for Taxpayers Making $10 Million +
More than half of reported income is investment income.	2.3%	7.1%	32.0%	15.3%
Between one tenth and half of reported income is investment income.	7.3%	14.1%	20.0%	25.3%
Less than one tenth of reported income is investment income.	90.4%	21.3%	48.0%	31.5%

Source: Institute on Taxation and Economic Policy tax model, October 2011

people.[21] As the report explains, there are two reasons for this. First, the personal income tax has lower rates for two key types of investment income, capital gains and stock dividends. Second, investment income is exempt from payroll taxes (which will change to a small degree when the health care reform law takes effect).

The report compares two groups of taxpayers, those with income in the $60,000 to $65,000 range (around what Buffett's famous secretary is said to make), and those with income exceeding $10 million.

For the first group, about 90 percent have very little investment income (less than a tenth of their income is from investments) and consequently have an average effective tax rate of 21.3 percent. For the second group (the Buffett and Romney group) about a third get the majority of their income from investments and consequently have an average effective tax rate of 15.3 percent. This is the problem that the Buffett Rule would solve.

The most straightforward way to implement the Buffett Rule would be to eliminate the breaks in the personal income tax for capital gains and stock dividends. As explained earlier, this would raise $533 billion over a decade.

Impacts of Senator Sheldon Whitehouse's "Buffett Rule" in 2014

Minimum Tax = 0.3 x (AGI-charitable deductions) phased in between $1m and $2m

Income Group	Average Income	Total Tax Change ($billions)	Average Tax Change	Percent with Tax Increase	Share of Tax Increase
Lowest 20%	$ 14,597	$ —	$ —	—	—
Second 20%	29,474	—	—	—	—
Middle 20%	47,333	—	—	—	—
Fourth 20%	78,084	—	—	—	—
Next 15%	135,574	—	—	—	—
Next 4%	293,500	—	—	—	—
Top 1%	1,634,204	15.0	10,213	6%	100%
ALL	$ 81,089	$ 15.0	$ 101	0%	100%

Source: Institute on Taxation and Economic Policy (ITEP), March 2012.

Senator Sheldon Whitehouse of Rhode Island has introduced a bill that would take a more roundabout approach by imposing a minimum tax equal to 30 percent of income on millionaires. This would raise much less revenue than simply ending the break for capital gains, for several reasons. First, taxing capital gains as ordinary income would subject capital gains to a top rate of 39.6 percent in years after 2012, while Senator Whitehouse's minimum tax would have a top rate of just 30 percent. Second, the minimum tax for capital gains income would effectively be even

[21] Citizens for Tax Justice, "How to Implement the Buffett Rule," October 19, 2011. http://www.ctj.org/pdf/buffettruleremedies.pdf; Citizens for Tax Justice, "The Need for the 'Buffett Rule': How Millionaire Investors Pay a Lower Rate for Middle-Class Workers," September 27, 2011. http://www.ctj.org/pdf/buffettrulereport.pdf

less than 30 percent because it would take into account the 3.8 percent Medicare tax on investment income that was enacted as part of health care reform. Third, even though most capital gains income goes to the richest one percent of taxpayers, there is still a great deal that goes to taxpayers who are among the richest five percent or even one percent but not millionaires and therefore not subject to the Whitehouse proposal.

Other reasons for the lower revenue impact of the Whitehouse proposal (compared to repealing the preference for capital gains) have to do with how it is designed. For example, Senator Whitehouse's minimum tax would be phased in for people with incomes between $1 million and $2 million. Otherwise, a person with adjusted gross income of $999,999 who has effective tax rate of 15 percent could make $2 more and see his effective tax rate shoot up to 30 percent. Tax rules are generally designed to avoid this kind of unreasonable result.

The legislation also accommodates those millionaires who give to charity by applying the minimum tax of 30 percent to adjusted gross income less charitable deductions.

Repeal last-out, first-out (LIFO) and lower of cost or market (LCM) inventory rules.
10-year revenue impact: +$98 billion[22]

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 so your profit is $20 (ignoring any other expenses). But the LIFO method used by some businesses, notably oil companies, 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 legislation in conference, so oil companies still get to use LIFO.) The Obama administration has, reasonably, proposed repeal of LIFO.

A related accounting practice is the "lower of cost or market" (LCM) method that is sometimes used by businesses that do not use LIFO. Under the LCM method, businesses value their inventory at its cost or its market value, whichever is less, resulting in smaller reported profits.

Eliminating the LIFO and LCM accounting methods would raise $98 billion over ten years according to CBO. The Treasury Department estimates that President Obama's proposal to eliminate these

[22] CBO, 2011, p. 177.

accounting methods would raise $87 billion over a decade (but the President's proposal would not go into effect until the second year of the decade for the revenue estimate).[23]

Enact a financial crisis responsibility fee on large financial institutions.
10-year revenue impact: +$61 billion[24]

As part of his fiscal year 2013 budget plan, President Obama proposes an annual fee of 0.17 percent of the value of the riskier assets held by the 50 largest financial institutions (those with assets of more than $50 billion each). The stated purpose of the fee is to "recoup the costs of the TARP program as well as discourage excessive risk-taking."[25]

The rate and revenue impact of the President's proposed fee has varied over the past three years, and the explanation given by the administration is the changing estimates of the cost of TARP.

But the cost of TARP is largely beside the point because the second purpose of the fee — discouraging excessive risk-taking by financial institutions — seems far more important. Banks should pay a hefty fee to help pay for the implicit government guarantee that they now seem to have.

Excessive risk-taking by the financial industry as a whole over the last decade led to a systemic meltdown. As a result, the banking system as a whole began to fail, meaning businesses were unable to obtain credit, making it impossible for them to function. The bailout propped up the banking system to avoid a deeper recession, but the distasteful side effect is that the largest banks know full well that they are now considered "too big to fail."

So now the biggest banks have insufficient incentive to avoid the sort of risk-taking that led to the collapse. The implicit government guarantee gives them a special advantage that smaller banks don't have, since banks that are not considered "too big to fail" are less likely to be bailed out by the federal government. The proposed fee would seem to address these problems at least to some extent, by reducing the incentive for risk-taking as well as the advantage that the largest banks have over smaller banks.

Another attractive feature about the proposed bank fee is that it might be difficult or impossible for banks to shift the costs to their customers. In theory, customers could respond by taking their business to a smaller bank that is not subject to the fee. As a result, the fee will instead come out of the banks' profits that are paid to shareholders.

Progressive supporters of the proposed bank fee have been joined by some noted conservatives. Greg Mankiw, Chairman of President George W. Bush's Council of Economic Advisers, and David

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[23] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," February 2012, pages 130-131, 204. http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf
[24] Dept. of Treasury, page 203.
[25] Dept of Treasury, page 101.

Stockman, director of the Office and Management and Budget under President Reagan, both support the bank fee.[26]

Repeal fossil fuel tax breaks.
10-year revenue impact: +$38 billion[27]

For several years, lawmakers have debated repealing tax subsidies for oil and gas companies. Some support these reforms as a way to help the environment by redirecting resources away from dirty fuels, while other simply think it does not make economic sense for the government to give tax subsidies to an industry that is already extremely profitable. The reforms listed here have all been proposed by President Obama.

Repeal the deduction for "intangible" costs of exploring and developing oil and gas sources. The "intangible" costs of exploration and development generally include wages, costs of using machinery for drilling and the costs of materials that get used up during the process of building wells. Most businesses must write off such expenses over the useful life of the property, but oil companies, thanks to their lobbying clout, get to write these expenses off immediately. **The President's proposal to close this loophole would raise $13.9 billion over ten years.**

Repeal "percentage depletion" for oil and gas properties. Most businesses must write off the actual costs of their 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, some oil companies get 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. **The President's proposal to close this loophole would raise $11.5 billion over ten years.**

Reduce the break for amortization of geological and geophysical expenditures. As a general rule, the costs of creating a long-term capital asset are considered part of the value of the asset that is written off over its useful life (deducted over the period of time that the asset will likely wear out). But oil and gas companies don't have to follow this general rule when they search for and locate oil or gas on a given piece of land. They get to amortize (write off the costs) far more quickly, meaning they receive tax deductions earlier, making these deductions much more valuable. The Energy Policy Act of 2005 provided a two-year amortization period for the costs of searching for oil and gas. The tax cut bill Congress passed in 2006 changed the rule to allow a five-year amortization. The President proposes to change the rule to allow seven-year amortization. **The President's proposal to reduce this loophole would raise $1.4 billion over ten years.**

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 (such as the right to extract oil, gas or minerals). The U.S. tax code

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[26] Greg Mankiw, "The Bank Tax," January 15, 2010, *Greg Mankiw's Blog*. http://gregmankiw.blogspot.com/2010/01/bank-tax.html; David Stockman, "Taxing Wall Street Down to Size," January 19, 2010, *New York Times*. http://www.nytimes.com/2010/01/20/opinion/20stockman.html

[27] Dept. of Treasury, page 203. Revenue estimates for proposals are listed separately, and the sum of those included here is $37.5 billion.

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 President proposes to change the rules to end this practice, which is often used by oil and gas companies, as well as others (particularly mining companies). **The President's proposal to reform these rules would raise $10.7 billion over ten years.**

Reduce the "Mark Zuckerberg loophole" for stock options.
10-year revenue impact: +$25 billion[28]

For several years, Senator Carl Levin has championed legislation to limit corporate tax deductions for stock options given to highly compensated employees to the amount of the stock option expense that companies report to their shareholders.

Stock options are rights to buy stock at a set price. Corporations sometimes compensate employees (particularly top executives) with these options. The employee can wait to exercise the option until the value of the stock has increased beyond that price, thus enjoying a substantial benefit.

Tax deductions for stock options were very controversial during the years when the book rules (accounting rules regarding how companies report expenses to shareholders) conflicted entirely with the tax rules (regarding how such expenses are deducted from a company's income when calculating corporate income taxes). The book rules did not require companies to count stock options as an expense while the tax rules did allow companies to count them as an expense to be deducted from their taxable income. Of course, corporations like to report the largest possible profits to shareholders and the lowest possible profits to the IRS for tax purposes, so this situation suited corporate executives.

In other words, corporations were allowed to tell their shareholders one thing and then tell the IRS something different about how stock options affected their profits. The book rules and the tax rules were made less divergent in 2006, but they still differ. The book rules were changed so that corporations report an expense for stock options both to shareholders and to the IRS, but the book write-offs often are still far less than the tax write-offs.

Barring corporations from counting stock options as an expense for either book or tax purposes would make more sense. There is no cost to a corporation when it grants stock options, so there is no need for a deduction from taxable income.[29] Corporations compensating employees with stock options are like airlines that compensate employees with free rides on flights that are not full. In both cases the employee receives a form of compensation, and in neither case does it cost the

[28] Senator Carl Levin, "Summary of Cut Unjustified Tax (CUT) Loopholes, S.2075," February 7, 2012. http://www.levin.senate.gov/newsroom/press/release/summary-of-cut-unjustified-tax-cut-loopholes-s2075
[29] For a more detailed explanation, see Citizens for Tax Justice, "Putting a Face(book) on the Corporate Stock Option Tax Loophole," February 7, 2012. http://www.ctj.org/pdf/FacebookReport.pdf

employer anything.[30] No deduction is allowed for the free flights, so none should be allowed for stock options.

Facebook recently announced that it would take $7.5 billion in tax deductions for stock options paid to favored employees, mostly to co-founder Mark Zuckerberg. These tax deductions will wipe out its tax liability for this year and result in excess deductions that can be carried back against previous years' taxes, meaning Facebook will likely receive refunds from the IRS for previous taxes paid. In other words, Facebook incurred no real cost but nonetheless wiped out its tax liability, probably for years.

A more modest reform would be to make the book write-offs for stock options identical to what corporations take as tax deductions. Currently, the oddly-designed book rules require the value of the stock options to be guessed at when the options are issued, while the tax deductions reflect the actual value when the options are exercised. Given the uncertainty of what the options will be worth when exercised and the fact that corporations have an incentive to guess on the low side (so they can report higher profits to shareholders), it's no wonder that their guesses are always wrong, and typically too low.

The legislation introduced by Senator Levin would not bar companies from counting stock options as an expense for book or tax purposes. It would, however, bar companies from taking tax deductions for stock options that are larger than the expenses they booked for shareholder-reporting purposes. It would also remove the loophole that exempts compensation paid in stock options from the existing rule capping companies' deductions for compensation at $1 million per executive.

Close the "carried interest" loophole.
10-year revenue impact: +$21 billion[31]

If Congress does not eliminate the tax preference for capital gains (as explained earlier) then it should at least eliminate the loopholes that allow the tax preference for income that is not truly capital gains. The most notorious of these loopholes is the one that allows "carried interest" to be taxed as capital gains.

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 2012) that normally apply to wages and other compensation. (This arrangement also allows them to avoid payroll taxes, which apply to wages and salaries but not to capital gains.)

[30] In theory, there could be some cost to existing shareholders when individuals are allowed to buy stock for less than it's worth, but the same is true whenever a corporation issues new stock, and this does not generate a tax deduction for the corporation.
[31] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, p. 157. http://www.cbo.gov/doc.cfm?index=12085

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. How do we know that "carried interest" is compensation, and not capital gain? There are 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.[32]

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 (sometimes) even admit 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 2007 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."

The President has proposed to close the carried interest loophole, but his version of this proposal would only raise $13.5 billion over a decade, about ten billion less than the version of the proposal he offered in his first budget plan.[33] The President's version now clarifies that only "investment partnerships," as opposed to any other partnerships that provide services, would be affected. The Congressional Budget Office estimated that ending the carried interest loophole would raise $21.4 billion over a decade.

Close the "Gingrich/Edwards" loophole for "S corporations."
10-year revenue impact: +$11 billion[34]

A loophole often called the "John Edwards" loophole or the "Newt Gingrich" loophole allows owners of "S corporations" to avoid paying Social Security and Medicare taxes on their earnings.

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[32] Fund managers can invest their own money in the funds, but of course, tax treatment of any return on investments made with their own money would not be affected by the repeal of the carried interest loophole. (Profits from investments actually made by the managers themselves could still be taxed as capital gains).

[33] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," February 2012, page 204. http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf; Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," February 2010, page 151. http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2011.pdf

[34] Congressman Pete Stark, press release, "Stark Introduces Legislation to Close Medicare Tax Loophole," January 31, 2012. http://stark.house.gov/index.php?option=com_content&view=article&id=2356:news-stark-introduces-legislation-to-close-medicare-tax-loophole&catid=89:press-releases-2012

Payroll taxes are supposed to be paid on income from work. The Social Security payroll tax is paid on the first $110,100 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 in order to avoid payroll taxes.

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 taxable 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 S corporations 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.[35]

Two famous politicians have gained notoriety for using this loophole. The first was former Senator John Edwards, who actually claimed that his name was an asset, and that this asset (rather than his labor) was generating most of the income for his law firm (which was an S corporation). The second was former House Speaker Newt Gingrich, whose recently released tax returns demonstrated that he, too, took advantage of this tax dodge.

Legislation to close this loophole was first introduced as part of a tax "extenders" bill in 2010 in order to offset the cost of tax breaks and recently has been reintroduced by Congressman Pete Stark. The legislation would address situations in which an S corporation provides a service and generates most of its business based on the reputation or skills of three or fewer people. In other words, if this rule were in place already, John Edwards and Newt Gingrich probably would not have been able to avoid their payroll taxes.

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[35] 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

Appendix

Behavioral Responses to Taxing Capital Gains as Ordinary Income

The proposal to tax capital gains as "ordinary" income would raise the tax rates for capital gains from 10 percent and 20 percent (the rates that will apply again starting in 2013 if the Bush tax cuts expire) to the ordinary income tax rates as high as 39.6 percent.

Some analysts believe that investors would respond to this tax increase by holding onto assets longer, meaning there would be fewer capital gains to tax. These behavioral responses, the thinking goes, would reduce the amount of revenue raised by increasing tax rates on capital gains and (according to the most extreme proponents of this thinking) could even lead to a net decrease in tax revenue.

The $533 billion revenue estimate we calculate for this proposal takes into account what we believe are the strongest behavioral responses that this proposal could produce. We begin with a "static" estimate (one that does not take into account behavioral responses) that the proposal would raise $805 billion over a decade. We then estimate that behavioral responses could reduce the revenue impact to $533 billion over a decade, but no less than that.

The Joint Committee on Taxation (JCT), which has responsibility for estimating the revenue impact of proposals before Congress, might conclude that these behavioral effects would have a much greater effect and that the proposal would therefore raise much less revenue.

The Congressional Research Service (CRS) concludes that JCT vastly overstates this effect. (See Jane G. Gravelle, "Capital Gains Tax Options: Behavioral Responses and Revenues," Congressional Research Service, August 10, 2010.)

CRS notes that JCT seems to assume a high elasticity of capital gains realizations in response to tax increases. This assumption seems to be influenced by studies done during the 1980s leading up to the tax debates during the first Bush administration. Many of these studies were flawed because they mistook short-term behavioral responses for permanent behavioral responses. CRS explains that later studies in the 1990s corrected for this.

For example, a later study by Leonard Burman and William Randolph compared taxpayers in different states with different state-level tax rates on capital gains. While the taxpayers were found to respond in the short-term to changes in tax rates, the permanent differences between their *states*' capital gains tax rates had no effect, demonstrating that behavioral effects of capital gains tax changes exist mostly in the short-term and not in the long-term. (See Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital Gains Tax Change in Panel Data," American Economic Review, vol. 83, September 1994, 794-809.)

We use the same overall approach to calculate the behavioral responses to capital gains tax increases that is used by JCT, but we replace JCT's "response parameter," or assumption about how capital gains realizations respond to tax rates, with the response parameter that Burman and Randolph concluded is most accurate.

JCT starts with CBO's baseline projected capital gains realizations, and the "response parameter" or coefficient that they believe describes how these realizations are affected by the marginal tax rate.

They begin with the equation[36]

LN(RCG) = a + b * MTR

RCG is capital gains realizations, so LN(RCG) is the natural log of capital gains realizations. The variable *b* is the "response parameter," the coefficient that describes how realizations are affected by the marginal tax rate, which is MTR. The variable *a* represents other factors that affect capital gains realizations.

The inverse of the natural log is the base of the natural log (e) raised to the power of that number. So the above equation can also be stated as

RCG = EXP(a + b*MTR).

To estimate the effects of a *change* in marginal capital gains tax rates, the variable *a* is not needed.

Thus, the change in realizations that would occur after a change in the marginal tax rate, compared to the realizations that occur under the current tax rate, can be expressed as

= EXP(b*dMTR)

where dMTR is the change in the marginal tax rate.

For example, if this equation equals .88, this means that after enactment of the tax rate increase we should expect to see 88 percent of the capital gains realizations that would occur otherwise. The tax rate increase would reduce capital gains realizations by 12 percent.

The percentage change in realizations in response to a change in the marginal tax rate can therefore be expressed as

= EXP(b*dMTR) – 1

And the change in realizations can be expressed as

= (EXP(b*dMTR) – 1) * ltcg

where ltcg is the baseline capital gains realizations that would occur absent any change in the marginal tax rate.

JCT concluded that the response parameter, the coefficient *b*, was –3.51. Burman and Randolph, using what we believe is a more rigorous methodology, concluded that it is just –1.0.

[36] Joint Committee on Taxation, "Explanation of Methodology Use to Estimate Proposals Affecting the Taxation of Income from Capital Gains," JCS-12-90, March 27, 1990, page 54.

We estimate that if capital gains are taxed as ordinary income starting in 2013, the average effective marginal tax rate would rise from 21.5 percent to 34.2 percent. (This includes the personal income tax plus the 3.8 percent Medicare tax that will be in effect). The rate change would therefore be 12.7 percent.

If the change in capital gains realizations in response to a change in the tax rate is
= (EXP(b*dMTR) – 1) * ltcg

Then, assuming capital gains realizations in 2014 are projected to be $555.6 billion, and assuming Burman and Randolph's response parameter of –1, the change in capital gains realizations would be

= (EXP((-1)*0.127) - 1) * $555.6 billion

= – $66.3 billion

The revenue impact of behavioral responses to a capital gains tax increase can be determined by multiplying the induced change in capital gains realizations (minus $66.3 billion in this case) by the new capital gains tax rate and adding that amount (which is a negative number) to the "static" revenue estimate.

-$66.3 billion * 34.2% = -$22.7 billion

Although using the average effective marginal tax rates in the formula gives reasonable estimates of the likely change in capital gains, we used different marginal rates for taxpayers in different tax brackets to improve the resulting estimates. As a result, we estimate that capital gains realizations would decrease the revenue impact by $23.8 billion, slightly more than the figure above.

Our static estimate for this proposal in 2014 is $70.5 billion. We subtract the $23.8 billion (the reduction in the revenue impact due to behavioral responses) and conclude that this proposal would raise $46.7 billion in 2014. Over the 2013-2022 period, this proposal would raise $533 billion.