The Tax Reduction and Reform Act of 2007: An Overview

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Summary

On October 25, 2007, Chairman Charles B. Rangel of the House Ways and Means Committee announced his tax revision proposal, H.R. 3970, the Tax Reduction and Tax Reform Act of 2007. One of the objectives of the plan was to address the problem with the individual alternative minimum tax (AMT), a provision that was originally aimed at high-income taxpayers' preferences but, because it was not indexed, is increasingly reaching upper middle class taxpayers. The most significant provisions, measured by revenue effect, were a revision in 2007 and subsequent repeal of the AMT (costing $845 billion over 10 years) and an additional tax on high-income individuals (raising $832 billion).

The plan also contained other tax revisions for individuals, to produce a roughly revenue neutral overall individual tax revision. Taxes were reduced for lower-income individuals by $86 billion, including an increase in the standard deduction, an increase in the earned income tax credit for families without children, and an increase in the refundability of the child credit. Taxes were increased for higher-income individuals through a restoration of the phaseout of personal exemptions and itemized deductions and a restriction on miscellaneous itemized deductions, for a total gain of $38 billion. These general provisions resulted in tax reductions for over 95% of taxpayers, with increases in tax liability at very high income levels. The individual section also contained base broadening provisions, raising $61 billion. The most important of these were increased taxes on managers of hedge fund and other investments, who tend to have high incomes.

The proposal also extended a number of expiring tax provisions for an additional year at a cost of $21 billion.

The plan also included a corporate/business package that cut the corporate tax rate from 35% to 30.5% (costing $364 billion over 10 years) and made an increased expensing allowance for small business equipment permanent (a $21 billion cost). Offsetting these losses were revenue raisers that resulted in a small net gain of $14 billion for this portion of the plan. The major revenue raising provisions were a repeal of the domestic production activity deduction, increased taxes for multinational corporations, and changes in inventory accounting.

Overall, the bill would lose $53.8 billion over five years and $7.5 billion over 10 years; thus, over the ten-year period it is close to revenue neutral as the loss is only 3/100 of 1% of income tax revenues.

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Major Provisions

Table 1 shows the major provisions and categories of minor provisions of H.R. 3970. The AMT provision includes a one year "patch" that would extend temporary increases in the exemption and credits that prevent the AMT, a provision originally targeted at very high-income individuals, from affecting many upper middle class taxpayers. The AMT revisions would lose revenues projected at $845.2 billion over the 10-year period FY2008-FY2017. Roughly offsetting this loss is an increase in taxes on higher-income individuals, in the form of an increased tax rate of 4% and 4.6%, which would gain $831.7 billion in revenues. These amounts are slightly under 5% of total individual income tax revenue projected to be collected over the 10-year period.

In addition to these major provisions, there are $86 billion in tax cuts for lower-income individuals, including an increase in the standard deduction, the earned income credit, and the refundability of the child credit. There are also additional taxes on higher-income individuals in the form of restrictions on itemized deductions and personal exemptions. There are also a series of base broadening provisions, with the most significant ones increases in taxes on investment managers.

Table 1. Major Provisions of H.R. 3970, The Tax Reduction and Reform Act of 2007

Provision	Revenue Effect, FY2008-FY2017 ($billions)	Share of Income Tax Revenues (%)
Individual Revisions	–0.4	0.00
Lower-Income Tax Cuts	–86.2	–0.40
AMT	–845.2	–3.91
Additional Tax on High Incomes	831.7	3.85
Other Provisions Affecting High Incomes	37.8	0.17
Base Broadeners	60.8	0.28

[1] Base broadening provisions expand the amount of income subject to tax or taxes collected; they raise revenue and largely involve restricting deductions and exemptions, although one of the major ones imposes a higher rate (treating certain income as ordinary income rather than capital gains).

Provision	**Revenue Effect, FY2008-FY2017 ($billions)**	**Share of Income Tax Revenues (%)**
Extenders	–21.3	–0.10
Primarily Affecting Individuals	–6.0	–0.03
Primarily Affecting Business	–15.2	–0.07
Other Extenders	–0.1	0.00
Corporate	14.2	0.07
Rate Reduction	–363.8	–1.68
Production Activities Deduction	114.9	0.53
International Provisions	139.0	0.64
Inventory/Accounting Provisions	113.9	0.53
Small Business Expensing	–20.5	–0.10
Intangible Expensing	20.7	0.10
Small Other Provisions	10.1	0.05
Total	**–7.5**	**–0.03**

Source: Joint Committee on Taxation.

The proposal also includes one-year extensions of 37 tax benefits that are scheduled to expire, mostly at the end of 2007. The most significant of these are the research and experimentation credit, the deduction for state and local sales taxes, and the 15-year recovery period for certain lease-hold improvements and restaurant property.

Finally the proposal reduces the top corporate tax rate from 35% to 30.5%, with the change offset by a series of base broadening provisions, with the most important ones repealing the domestic production activities deduction, a set of international tax provisions, and two inventory revisions.

As indicated by the table, the individual section is essentially revenue neutral (raising as much revenue as it loses), the extenders have a very small loss, and the corporate revisions a very small gain. Overall the bill has a negligible effect on revenues over a 10-year period. Note, however, that these measures reflect the standard baseline for legislative proposals that assumes the 2001 tax cuts are allowed to expire. Were the tax cuts to be extended, the revenue loss associated with the repeal of the AMT would be larger, or, to put it another way, if H.R. 3970 were enacted, the cost of extending the tax cuts would be larger. This interaction occurs because the lower tax rates enacted in 2001 were not fully realized (were "taken back") for many taxpayers, especially as time passed, because these taxpayers were subject to (or became subject to) the AMT.[2]

The provisions in the bill that provide the AMT patch through 2007 and the extenders are included in H.R. 3996, a bill passed by the House on November 9, 2007 that deals with more immediate issues.[3] The revenue cost of the AMT patch in that bill is $50.6 billion, as compared to

[2] CRS Report RS21817, *The Alternative Minimum Tax (AMT): Income Entry Points and "Take Back" Effects*, by (name redacted).

[3] H.R. 3996 includes some other relief provisions, including eliminating tax on mortgage debt forgiven and ending the private debt collection program for the Internal Revenue Service. It also includes revenue raisers, among them taxes on (continued...)

$49.6 billion in H.R. 3970. The difference apparently reflects a larger increase in the AMT exemption to allow for real income growth.

Individual Tax Revision

The individual tax revisions constitute the major portion of the bill, in size of tax changes. The individual tax package is roughly revenue neutral, but it redistributes tax burdens. The sections below discuss the revisions and some of the issues associated with them. The final section summarizes the overall distributional effect.

Revisions in the AMT

The AMT has become a major issue and eliminating it and paying for the resulting revenue cost is the most important feature of the bill in terms of revenue. The objective of the AMT was originally to impose taxes on higher-income individuals who were otherwise paying low taxes because of tax preferences (i.e., tax benefits). Because AMT exemptions were not indexed for inflation, and because of other revisions, the AMT began to affect individuals in the upper middle incomes, and no longer affected the very highest income individuals.[4] Increasingly the AMT is a tax that is triggered by provisions that it was not originally focused on, such as personal exemptions and certain itemized deductions.

The bill's AMT provisions are in two parts: an extension of the "patch" for 2007 (costing $49.6 billion) which increases and indexes the exemption from the AMT and extends allowances of certain credits, and the subsequent repeal of the AMT (costing $797.7 billion). Without the patch, the AMT, which initially applied to less than 20,000 taxpayers, and applied to 3.5 million in 2006, will affect 24 million taxpayers in 2007. These amounts will grow over time.

Tax Benefits for Lower-Income Individuals

H.R. 3970 contains three provisions targeted at lower-income individuals that cost $86 billion overall: an increase in the standard deduction; an increase in the earned income credit for families without children; and an increase in the refundability of the child credit.[5] The revenue cost of the components is shown in **Table 2**.

(...continued)

investment managers and a delay of the worldwide interest allocation rule for the foreign tax credit, discussed below.

[4] For a general discussion of the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by (name redacted). See also CRS Report RS22909, *The Alternative Minimum Tax for Individuals: Legislative Activity in the 110th Congress*, by (name redacted) and (name redacted), and CRS Report RL33899, *Modifying the Alternative Minimum Tax (AMT): Revenue Costs and Potential Revenue Offsets*, by (name redacted).

[5] For further discussion of these issues see CRS Report RL33755, *Federal Income Tax Treatment of the Family*, by (name redacted), CRS Report RL31768, *The Earned Income Tax Credit (EITC): An Overview*, by (name redacted), and CRS Report RL34715, *The Child Tax Credit*, by (name redacted).

Table 2. Provisions of H.R. 3970 Affecting Lower-Income Taxpayers

Provision	Revenue Effect FY2008-FY2017 ($billions)
Standard Deduction	-47.9
Earned Income Credit	–29.1
Child Credit Refundability	–9.1
Total	**–86.2**

Source: Joint Committee on Taxation.

The bill would increase the standard deduction by $850 for married couples, $425 for singles, and $625 for heads of households. The standard deductions for 2007 are currently $10,700, $5,350, and $7,850 respectively. This change would increase the number of lower-income taxpayers who do not pay taxes, and also decrease the share of taxpayers that itemize, a change that would simplify tax compliance. This increase in the standard deduction accounts for $47.9 billion of the revenue loss.

The proposal would also increase the earned income tax credit for single individuals and married couples without children, as well as the credit's phase out range. These families receive a small earned income tax credit of 7.65% on income up to $5,590, compared to a 34% credit for families with one child and 40% for families with two children, both applicable to larger incomes. The credit phases out (for 2007) at $12,590 for singles and $14,590 for childless couples. The proposal would increase the amount eligible for the credit from $5,280 to $10,900 and the credit rate to 15.3%. This provision costs $29.1 billion.

Some might resist the expansion of the earned income credit to families without children, taking the view that the program is a welfare program run through the tax system and thus should be directed at the more vulnerable population as are many other welfare programs (such as Medicaid and general income support programs). From the viewpoint of tax equity, however, the restricted benefits for those without children cause poor families without children to pay taxes while families with children that have a much higher standard of living have tax subsidies, which are enhanced by the child tax credit.

The third proposal would increase the refundability of the child tax credit, that is, the rebate of the tax for families with little or no tax liability. Currently, the child tax credit is refundable for 15% of income over $11,300; hence the credit is not refundable or fully refundable to low-income families. The proposal would decrease the threshold to $8,500 and no longer index it, so it would continually decline in real value over time. This provision costs $9.1 billion.

Tax Increases on High-Income Individuals

Three revenue raising provisions apply to high-income individuals and roughly offset the losses associated with the repeal of the AMT: a tax on high adjusted gross incomes, a restoration of provisions that phase out personal exemptions and itemized deductions for high-income taxpayers, and an increase in the floor for miscellaneous itemized deductions. The revenue impact of the provisions is shown in **Table 3**.

By far the largest of these provisions, an $831.7 billion revenue gain, is a proposal to impose a surtax of 4% on adjusted gross income above an amount that would be set by the Treasury Secretary where 90% of individuals above that amount would otherwise be subject to the AMT. This amount would, however, not be less than $200,000. There would be an additional 0.6% tax on incomes above $500,000 ($250,000 for singles), for a total additional tax of 4.6% on such income. Unlike an ordinary rate increase, these increased taxes would apply to adjusted, not taxable, income. Thus they would increase tax rates on all income whether or not it is eligible for preferences such as itemized deductions or lower rates (Capital gains and dividends are taxed at a maximum rate of 15% through 2010; after that point the dividend preference will end and the capital gains tax will rise to 20%).

Table 3. Provisions of H.R. 3970 Affecting Higher-Income Taxpayers

Provision	Revenue Effect FY2008-FY2017 ($billions)
Tax on High Adjusted Gross Incomes	831.7
Restoration of Itemized Deduction and Personal Exemption Phase-Outs	28.6
Increase in Miscellaneous Itemized Deduction Floor	7.1
Interaction Term	2.8
Total	**870.2**

Source: Joint Committee on Taxation.

The second provision would restore the phase out of personal exemptions and itemized deductions for high-income individuals, commonly referred to as PEP and Pease. Under the terms of the 2001 tax cut, these phase outs were to be gradually eliminated. This provision has no effect on revenues after FY2012 because this phaseout's elimination occurs only through 2010, as the 2001 tax cuts sunset in 2010, but overall would raise $28.6 billion.

The third provision would increase the current 2% floor under miscellaneous itemized deductions to 5% for income over $500,000 ($250,000 for single returns). This is a deduction that was not allowed under the AMT. It raises $7.1 billion. Also included in the table is an interaction term to cover the relationships among these provisions and with the AMT repeal.

The rationale for these increases is that the AMT was aimed at higher-income individuals and thus taxes should be raised on these individuals to pay for AMT repeal. The use of adjusted gross income as a base imposes the tax on items such itemized deductions and preferentially taxed dividends and capital gains, the latter a very significant share of income at high income levels. When the original AMT was imposed, the major preference subject to the AMT was excluded capital gains. But when capital gains preferences, which were eliminated in 1986 when the capital gains exclusion was eliminated, were restored and expanded in 1997 and 2003 via a lower rate, they were not included as preferences. That is, capital gains, and subsequently dividends, are still taxed at the lower rate of 15% as they are under the regular tax, rather than the 26% (or 28%) AMT rate.

At the same time, there is some resistance to increasing marginal tax rates, and also resistance to increasing taxes on dividends and capital gains which form part of the double taxation of corporate income (although the corporate rate is lowered in the proposal as well). In addition, some economists believe that higher capital gains taxes significantly deter capital gains

realizations and may even lose revenue; other researchers have, however, found a negligible response.[6]

Individual Base Broadening

The bill also includes several individual provisions that are virtually all base broadening provisions and raise revenue. As shown in **Table 4**, only one of these individual provisions, which affects taxes on tax exempt organizations, loses revenue.

The first provision addresses the tax treatment of investment managers, such as managers of hedge funds, and would treat investment income that is currently treated as capital gains as ordinary income, based on the view that this income is not investment income, but compensation for services. This income is commonly referred to as "carried interest."[7]

Table 4. Individual Base-Broadening Provisions of H.R. 3970

Provision	Revenue Effects FY2008-2017 ($billions)
Treat Investment Managers Income as Ordinary Income	25.7
Deferred Compensation for Investment Services	22.6
Elimination of Unrelated Business Income Tax for Certain Partnerships	−1.3
Tax Sharing Sales, Gain Treated as Ordinary Income	0.1
Employment Taxes of S Corporations	9.4
Basis Reporting for Brokers	4.3
Total	**80.8**

Source: Joint Committee on Taxation.

There are two provisions relating to the investment in offshore hedge funds by tax exempt investors. Earnings of domestic tax exempt investors are exempt from income tax, but there is an unrelated business income tax (UBIT) which applies to certain investments not related to their tax-exempt purpose. Currently, debt-financed investments are subject to the these taxes. In the case of partnership investments, the flow through of attributes can result in an imposition of the UBIT. In the case of domestic corporations there is no flow through, but a tax is imposed at the corporate level. Offshore investments in some cases use corporate "blocker" firms that are structured to avoid corporate tax but prevent the flow through of attributes, so no tax is applied to tax exempt investors at any point. They also attract non-taxable foreign investors. The first of these two provisions relating to offshore investments by tax exempt entities would require investment managers who have deferred compensation through these operations to be taxed currently. Normally, where deferred compensation benefits are paid, the employee is not taxed but

[6] See the discussion of effects of increasing taxes on capital gains and dividends as a revenue offset for AMT reform in CRS Report RL33899, *Modifying the Alternative Minimum Tax (AMT): Revenue Costs and Potential Revenue Offsets*, by (name redacted). The appendix to that report contains a review of the literature on the empirical evidence for a realizations response, with more recent studies finding lower responses.

[7] See CRS Report RS22717, *Taxation of Private Equity and Hedge Fund Partnerships: Characterization of Carried Interest*, by (name redacted).

the firm is not able to take a deduction. The lack of a corporate deduction, which gains revenue, offsets the failure to tax the employee, which loses revenue. This offsetting revenue gain does not occur when the effective employer is tax exempt, and the bill's current taxation of deferred compensation restores the tax.

The second provision relating to tax exempt hedge fund investment (the third provision listed in **Table 4**, which loses revenue) would eliminate the UBIT for partnerships, which would remove the differential tax treatment that encourages offshore investment in corporate blocker hedge funds relative to domestic partnerships. The revenue loss may be small because very little investment involves domestic partnership investments. There is some disagreement about the direction to take for UBIT. The provision is this bill mirrors H.R. 3501, introduced by Congressman Levin. Supporters of this view may wish to reduce the incentive to invest through offshore entities, or may view the inclusion of debt financed passive investment as too broad a scope for the UBIT. An alternative approach would be to conform the offshore treatment to the domestic investment by taxing these investments under the UBIT. The Senate Finance Committee, which held hearings on offshore investments on September 26, 2007, included witnesses that discussed the growth of educational institution endowments in part via these offshore investments because they continued low spending rates out of these returns.[8] This hearing also considered direct requirements for spending as an alternative to addressing the offshore UBIT issue.

The fourth provision in **Table 4** refers to sales of depreciable property between related parties, where any gain on the sale is taxed as ordinary income. The provision treats as a sale between related parties any sale where there is a payment from the buyer to the seller for depreciation-related tax benefits realized by the transferee.

The fifth provision in **Table 4** would impose the same payroll treatment on Subchapter S service firms (Subchapter S firms are incorporated as businesses but elect to be taxed as partnerships) that apply to ordinary partnerships and proprietorships in active business, namely that all income is subject to the payroll tax. Currently, Subchapter S partners are required to pay payroll taxes on an amount that in theory should reflect the value of their labor services, while ordinary partners and proprietors must pay tax on all income. S Corporations have an incentive to evade the payroll tax by understating the value of labor services for their shareholders. The tax would apply to all income received as shares relating to service income and there would be conforming changes to limited partners of service partnerships.

The final provision in **Table 4** would require brokers to report the basis of sales of securities to the Internal Revenue Service (IRS). Basis is generally the amount originally paid for the security and is subtracted from gross proceeds to measure capital gains. Currently only gross proceeds are reported. Basis reporting should help reduce evasion of capital gains taxes because the IRS currently has no third party information on the basis of assets which is necessary to determine capital gain.

[8] Witness statements are posted at http://finance.senate.gov/sitepages/hearing092607.htm.

Distributional Effects

The package of individual changes in the individual tax portion of the bill would be roughly revenue neutral (a slight revenue loss) but would redistribute tax burdens. **Table 5** shows the change in tax liability and the percentage change in after tax income (a measure of the effect on income distribution, due to the broad based individual provisions) reported in a study of the broad based individual provisions by the Urban Institute-Brookings Institution Tax Policy Center[9]. The distributional effects would change over time, so the initial and final years are shown.

As **Table 5** indicates, the tax burden would be reduced on lower, middle, and upper middle income taxpayers, but increased on very high incomes. The reduction at the lower incomes is due to the set of low-income tax provisions: the standard deduction, earned income credit, and refundable child credit. The reduction in the middle and upper middle classes is due to the repeal of the AMT, while the increases at the top reflect the surtax on adjusted gross incomes.

In terms of dollar amounts (not shown here but available in the Tax Policy Study) even the $200,000 to $500,000 income class on average receives a tax cut; on average tax increases do not begin until the $500,000 to $1,000,000 income class.

Table 5. Distributional Effects of Major Individual Income Tax Provisions of H.R. 3970

Distribution by Cash Income	Average Tax Change, 2008 ($)	% Change in After-tax Income, 2008	Average Tax Change, 2017 ($)	% Change in After-tax Income, 2017
Lowest Quintile	-85	1.0	–91	0.8
Second Quintile	–129	0.7	–68	0.3
Middle Quintile	–71	0.2	–194	0.4
Fourth Quintile	–201	0.4	–769	1.1
Top Quintile	80	–0.1	1249	–0.6
80-90 Percentile	–952	1.1	–1070	1.0
90-95 Percentile	–1,757	1.5	–1755	1.1
95-99 Percentile	–3,573	1.8	–474	0.2
Top 1%	34,190	–3.5	46,352	–3.9
Top 0.1%	212,607	–4.7	254,299	–4.0
Total	**–81**	**0.2**	**25**	**0.0**

Source: Urban-Brookings Tax Policy Center.

[9] Greg Leiserson and Jeffrey Rohaly, *Distributional Effects of the Major Individual Income Tax Provisions of H.R. 3970, The Tax Reduction and Reform Act of 2007*, Tax Policy Center, October 26, 2007, posted at http://www.taxpolicycenter.org/publications/url.cfm?ID=411564.

Extenders

Extenders are provisions that are enacted on a temporary basis and that must be reauthorized if they are not to expire. The revenue table provided by the Joint Committee on Taxation (JCT) divides extenders into those primarily affecting individuals, those primarily affecting businesses, and others (excise taxes and administrative issues).

Historically, most tax provisions were enacted on a permanent basis. Beginning in the early 1980s, with the temporary research credit, the number of extenders has grown dramatically. While some provisions were enacted on a temporary basis to permit their evaluation, budgetary constraints may be argued to be the major reason for the growth in the number of extenders, as a temporary provision has a smaller revenue cost than a permanent one.

In keeping with this growth, there are 37 extenders in the bill, which cost a total of $21 billion over a 10-year period. Many of these provisions have a negligible revenue effect. The most significant ones are the research and experimentation (R&E) tax credit, the optional state sales tax deduction, and the 15-year depreciation recovery period for leasehold and restaurant improvements. The R&E credit accounts for 40% of the total cost and the three provisions together account for 75%.

A more detailed discussion of these extenders and an individual listing is presented in the **Appendix**.

Corporate Tax Provisions

This section includes tax revisions that largely affect corporations, although some provisions also affect unincorporated businesses. The provisions, which involve both a rate reduction and broadening of the base, have a small net revenue gain. The major tax reduction is a reduced corporate tax rate (from 35% to 30.5%) that costs $364 billion over the 10-year period. The 2001 tax cuts generally focused on individual taxes, although there were some revisions in the corporate tax in 2004, and the 2003 reduction in tax rates on capital gains and dividends reduced the combined (firm and individual) tax burden on corporate investment. This proposal is the first since 1986 to include an overall corporate rate reduction.

A proposal to cut the corporate tax and broaden the base has also been recently discussed by the administration, which convened a conference on July 27, 2007 to address corporate issues. Some of that discussion focused on the expectation that other countries will lower their corporate tax rates. These discussions included the possibility of lowering the corporate statutory tax rate and broadening the base, although the base broadeners in H.R. 3970 are different in many cases from those explored by the administration. In general, a lower base and a broader base tends to lead to smaller economic distortions from a tax cut, although the merits of each base broadener are relevant to evaluating the proposal. There is, however, a limit to the degree to which the statutory tax rate can be lowered without transforming the corporation into a tax shelter for individuals.[10]

[10] Corporate tax issues and administration discusses are discussed in detail in CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by (name redacted) and (name redacted).

The second provision that loses revenue involves the small business expensing deduction. The law has a permanent provision that allows the expensing of $25,000 of equipment purchases, a provision that is phased out as income rises. A provision that increases the deduction to $125,000 and indexes it for inflation is effective through 2010. This provision would make the higher temporary level and indexing permanent. While such a provision favors small businesses over large ones, it simplifies tax compliance for smaller firms.[11] It costs $20.5 billion over 10 years.

Table 6 lists the corporate and business base broadening provisions. The most important provisions in revenue gain are the repeal of the production activities deduction, a repeal of last-in, last-out (LIFO) inventory accounting, and a provision to disallow expenses of parent corporations to the extent foreign source income is deferred.

Table 6. Corporate Base Broadening Provisions of H.R. 3970

Provision	Revenue Effects FY2008-FY2017 ($billions)
Repeal Production Activities Deduction	114.932
Allocation of Expenses for Repatriation of Foreign Income	106.385
Time of Foreign Currency Translation	0.002
Repeal of Worldwide Interest Allocation	26.204
Foreign Treaty Shopping	6.397
Repeal of Last-In, Last-Out (LIFO) Inventory Accounting	106.506
Repeal Lower of Cost or Market Inventory Accounting	7.146
Disallow Special Accounting Rule for C Corporations	0.225
Amortize Intangibles Over 20 Years	20.697
Economic Substance Doctrine	3.787
Dividend Received Deduction	4.596
Ordinary Income S Corporation Stock Option in ESOP	0.606
Termination Of DISC Rules	0.881
Gain in Spin-Off Transactions	0.235

Source: Joint Committee on Taxation.

The production activities deduction was enacted in 2004 and allowed a deduction for 9% of taxable income from domestic manufacturing and other production activities (such as construction). When fully effective it is the equivalent of reducing the top corporate tax rate from 35% to 31.85%. Trading off this provision for a rate reduction could also be seen as exchanging a somewhat more limited provision for a rate reduction that affects all corporations.

Some of the benefit of the deduction is received by unincorporated firms. In a letter dated September 22, 2004 to Senate staff members Mark Prator and Patrick Heck, responding to a query about the similar (although slightly different) Senate version of the provision, the Joint Tax

[11] See CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by (name redacted).

Committee indicated that three quarters of the benefit would have gone to corporations, 12 percent would have gone to Subchapter S firms (smaller incorporated firms that elect to be treated as partnerships) and cooperatives, 9 percent would have gone to partnerships, and 4 percent to sole proprietorships.[12]

The production activities deduction has been the subject of some criticism by both economists and other tax professionals. It distorts investment and, perhaps more importantly, presents difficult administrative issues which require firms that perform a variety of activities and who import intermediate goods from related firms to allocate profits to domestic use and to qualified activities. Aside from increasing compliance costs, the provision gives firms an incentive to characterize their activities as eligible (i.e., related to domestic production) and to allocate as much profit as possible into the eligible categories. Canada adopted a similar provision several years ago and repealed it because of the administrative complications.[13]

The next four base-broadening provisions relate to international tax issues. Under current law, income from foreign subsidiaries of U.S. firms is not taxed until it is repatriated (in the form of dividends) to the parent. At the same time, the parent is able to deduct costs, the most important of which is interest, even though some of that cost is associated with income that is not immediately subject to U.S. tax. Such treatment essentially allows firms to use foreign tax havens to effectively shift profit out of the United States and its tax system. The allocation rule would deny the portion of deductions associated with this income until the income is repatriated and subject to tax. Companies investing in non-tax-haven countries could avoid the allocation rule by repatriating income.

This allocation provision would also revise the foreign tax credit. Under current law firms are able to offset U.S. tax due on income that is received currently by the amount of foreign tax credits. The foreign tax credit is limited to U.S. tax due, but on an overall basis so that firms can use credits from high tax jurisdictions or imposed on highly taxed income to offset tax on income subject to lower foreign taxes. The allocation provision would allow credits for the share of foreign taxes paid that is equal to the share of total foreign income taxed currently, so that firms would not be able to choose repatriations to eliminate U.S. tax.

A provision allocating deductions was included in the proposals of the President's Advisory Panel on Tax Reform in 2005,[14] but would have been coupled with an exemption of active dividends of foreign subsidiaries. This change adopts the allocation rule, but not the exemption. Although there has been some support for an exemption provision, such a change is unlikely to contribute to economic efficiency or U.S. welfare.[15]

[12] The text of this letter was published in Tax Notes Today, 2004 TNT 187-70.

[13] For a discussion of the development of the production activities deduction and the issues, see CRS Report RL32103, *Comparison of Tax Incentives for Domestic Manufacturing: 108th Congress*, by (name redacted). The production activities deduction is also discussed in the Senate Committee on the Budget Print, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 109-072 (Washington: GPO), December 2006. This document is posted at the GPO site: http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.88&filename=31188.pdf&directory=/diskb/wais/data/109_cong_senate_committee_prints.

[14] *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, which can be found at http://www.taxreformpanel.gov.

[15] For a discussion of international tax reform, see CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by (name redacted).

An additional allocation provision would repeal a rule that involved world wide interest for the foreign tax credit. When income from abroad is subject to U.S. tax (either as branch income or repatriated income), a foreign tax credit is allowed for foreign taxes paid up to the U.S. tax due. For firms that have more foreign taxes paid than allowable credits, increasing the amount of income allocated abroad increases allowable foreign tax credits and reduces U.S. tax liability. Prior to 2004, U.S. source interest was allocated between foreign and domestic incomes based on relative magnitude of foreign and domestic assets. The 2004 provision included interest on foreign borrowing as well as debt-financed investment in the calculation, which would allocate more domestic interest to domestic source income, a reduction in interest allocated to foreign income and a resulting increase in the foreign tax credit limit. While there is some argument to be made for a worldwide allocation in measuring income more precisely, the allocation rules produce undesirable distortionary effects.[16]

Another provision relating to international tax issues is intended to reduce "treaty-shopping." The United States imposes withholding taxes on interest, royalties and similar payments to foreigners, but also engages in a number of treaties with other countries where these withholding rates are reduced. A firm in a country without a treaty can benefit by setting up a subsidiary in a treaty country to avoid the withholding tax, and this provision would eliminate that benefit.[17]

Two provisions relate to inventory accounting. Inventories are most important in the manufacturing and trade sectors of the economy.[18] The most significant is repeal of a provision that allows last-in, first-out (LIFO) accounting for inventories. In this form of inventory, the good being sold is assumed to be the last acquired and since, in general, prices tend to rise over time, this method increases the cost of the good sold and reduces profit (and therefore tax liability). The other inventory method is first-in, first out (FIFO), where the good sold is assumed to be the first acquired and thus includes any price increases in income. Firms must use the same inventory method for tax and book purposes, and as a result many firms that would find LIFO advantageous nevertheless use FIFO because profits reported to shareholders would be lower under LIFO. LIFO accounting may on average result in a more accurate measure of income because it has the effect of indexing cost and not capturing increases in value due to inflation. At the same time, when relative prices are changing, such as oil prices, it allows firms to avoid tax on windfall gains. In general, the economic consequences of taxing the return to inventories at a higher or lower rate are probably not very important: because of the short holding period for most inventories, the tax on the return is a very small part of the cost.

A second inventory provision eliminates the option to value inventories at market value rather than cost. Allowing this option permits the recognition of losses in inventory even though the items have not been sold, a treatment inconsistent with the general realization principle for gains and losses.

Aside from the domestic production activity deduction and the foreign and inventory provisions, three other provisions with significant revenue gains are amortization of intangibles, the economic substance doctrine, and the dividends received deduction. Under current law, acquired

[16] These distortions are relatively complicated to explain, but are discussed in more detail in (name redacted), "The 2004 Corporate Tax Revisions as a Spaghetti Western," *National Tax Journal*, vol. 58, September 2005, pp. 347-366.

[17] There is also a provision with a negligible revenue effect that alters the time of foreign currency translation.

[18] See (name redacted), *The Economic Effects of Taxing Capital Income* (Cambridge, MA, The MIT Press), 1994, p. 300.

intangibles (the excess of the value of a business over the value of its physical assets) are deducted over a 15 year period. The provision in H.R. 3970 increases the period to 20 years. The treatment for intangibles was enacted to simplify compliance and end disputes about the proper recovery period for intangibles which were not easily classified or separated from good will, which was assumed to be non-depreciable. At the time the issue was discussed, there was an argument that most intangibles for which depreciation was being argued to be appropriate by taxpayers (such as customer lists) were not really depreciable, since they were either self-generating or expenses undertaken to generate them were currently deductible. Thus, for most intangibles, recovery of acquired intangibles on acquisition is more appropriately regarded as a reduction in the capital gains tax, rather than a depreciation issue. In any case, there is likely to be relatively little effect on the decision to undertake the original investment, since the depreciation by subsequent purchasers is far in the future and subject to uncertainty.

Firms that enter into tax savings arrangements that are found not to have economic substance can have their tax benefits disallowed by the courts under what has become known as the economic substance doctrine. Proposals to introduce legislative standards into the doctrine, which is sometimes interpreted differently by different courts, have been included in a number of recent legislative proposals, especially by the Senate Finance Committee. In a manner similar to other proposals, H.R. 3970 would require a transaction to meet both an objective test (profit was made) and a subjective test (profit was intended). Penalties are also imposed. Supporters argue that the stricter test will not only reduce tax avoidance but also make treatment more consistent across the courts. Some tax attorneys are concerned that more specific rules might provide a roadmap to structuring arrangements that will pass the test. The U.S. Treasury disputes the revenue gains projected by the Joint Committee on Taxation and the current administration opposes the change, while the Clinton Administration supported it.

The third provision relates to inter-corporate dividend deductions. To prevent too much double tax at the corporate level, while still discouraging chains of partially owned corporations (which allows one corporation to exert control over many others) current law allows a partial, but not full, deduction for certain dividends paid between corporations. For a firm 80% owned, there is a 100% dividend deduction, for firms with 20% or more ownership, there is an 80% deduction, and for firms with less than 20% ownership there is a 70% deduction. The bill would reduce the 80% and 70% deductions to 70% and 60% (other than wholly owned subsidiaries). This provision would prevent a reduction in the intercorporate tax burden as a result of the rate cut. These taxes would actually rise slightly. For 20% owned the tax rises from 7% (0.3 times 35%) to 9.15% (0.2 times 30.5%); for less than 20% owners, the tax rises from 10.5% (0.3 times 35%) to 12.2% (0.4 times 30.5%).

The remaining provisions are relatively small in revenue impact. They include a provision that would prevent corporations from currently excluding payments from tax that may be uncollectible in the future, rather than taking these losses into account in the future. The stock option provision is aimed at taxpayers who hold options in Subchapter S corporations (corporations that elect to be taxed as partners) in combination with a large share of the stock held by a tax exempt employee stock ownership plan (ESOP). This treatment allows much of the S corporation to avoid tax while taxable shareholders accumulate value through options. Another provision would eliminate benefits for the remaining domestic international sales corporations (a form of organization that was eliminated in general many years ago). The final provision relates to tax free spin-offs of subsidiaries by parents, where tax is imposed on the parent if the parent receives value in excess of their tax basis in the subsidiary. Included in the definition of value is

debt of the parent assumed by the subsidiary. This provision would apply that tax to debt assumed prior to the spin-off.

Appendix. A Discussion of Extenders

Most of these extenders are discussed in a CRS Report RL32367, *Certain Temporary Tax Provisions ("Extenders") Expired in 2007*, by (name redacted) and (name redacted).[19]

Of the individual items in **Table A-1**,[20] the most significant in revenue impact is the optional deduction for state and local sales taxes.[21] The state and local deduction for sales taxes was repealed in 1986; in 2004 it was reinstated as an optional alternative to the deduction for state income tax and primarily benefits taxpayers in those states with no income tax.

The second largest in revenue cost of the extenders is the deduction for tuition, which covers some individuals who are not eligible for the permanent tuition tax credit.[22] There is also another education provision, allowing deductions for classroom teachers.[23] Three other provisions cost more than $100 million. The provision allowing individuals to contribute to charity from their Individual Retirement Accounts without including distributions in income and then deducting them was enacted in 2006. This provision was part of President Bush's original charity proposals and was contained in a number of legislative proposals relating to charitable deductions.[24] It benefits older individuals who do not itemize, those whose taxable social security benefits rise with their adjusted gross income, and persons who are subject the charitable contribution limits. The provision relating to combat pay addresses a problem created when, as a simplification measure, Congress did not allow tax exempt income to be considered in calculating the earned income tax credit. After the September 11 attack, many lower-income enlisted soldiers serving in combat zones lost the earned income credit and were actually harmed by the combat pay exclusion. This provision allows them the option of including their combat pay in determining the earned income credit. The provision relating to mortgage revenue bonds of veterans provides an exception to the requirement that tax exempt mortgage revenue bonds must be used essentially for first time home-buyers.

[19] They are also discussed in the Joint Committee on Taxation's *Description of the Chairman's Amendment in the Nature of a Substitute of H.R. 3996, The Temporary Tax Relief Act of 2007,*JCX-106-07, November 1, 2007, posted at http://www.house.gov/jct/x-106-07.pdf. Many of these provisions are also discussed in Senate Committee on the Budget Print, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 109-072, Washington, DC, U.S. Government Printing Office, December 2006, posted at http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.88&filename=31188.pdf&directory=/diskb/wais/data/109_cong_senate_committee_prints.

[20] **Table 5** also includes three provisions not described in the CRS extenders report that are related to mutual funds. The fourth item allows certain interest income held by foreign persons that would not be taxable if held directly to be exempt if channeled through a mutual fund if designated as interest related. The next to last provision provides that assets not invested in the United States and not included in the estates of foreigners would not be considered invested in the United States because they are invested though a U.S. Mutual Fund.

[21] See CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by (name redacted).

[22] See CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by (name redacted), and CRS Report RL32554, *An Overview of Tax Benefits for Higher Education Expenses*, by (name redacted) and Christian Gonzalez.

[23] See CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*, by (name redacted).

[24] See CRS Report RS21144, *Tax Incentives for Charity: An Overview of Legislative Proposals*, by (name redacted).

Table A-1. Extenders that Primarily Affect Individuals: Revenue Cost of H.R. 3970's One-Year Extension

Provision	Revenue Effects FY2008-FY2017 ($billions)
Deduction for Private Mortgage Insurance	–0.017
Deduction for State and Local General Sales Taxes	–3.584
Deduction for Qualified Tuition and Related Expenses	–1.389
Treatment of Certain Mutual Fund Dividends	–0.067
Parity in the Application of Certain Limits to Mental Health Benefits	–0.025
Contributions of Property Interests for Conservation	–0.052
Tax Free Distributions from IRAs to Charity	–0.452
Deduction for Classroom Expenses for Teachers	–0.191
Election to Include Combat Pay for Earned Income Credit	–0.019
Mortgage Bonds for Veterans Residences	–0.159
No Penalty on Retirement Plan Withdrawals for Those Called to Active Duty	–0.001
Estate Tax Look Through for Mutual Funds	negligible
Treatment of Mutual Funds Under FIRPTA	–0.010

Source: Joint Committee on Taxation.

Table A-2 lists the extenders that primarily affect businesses. By far the largest of these provisions is the tax credit for research and experimentation (R&E) expenditures, which was initially adopted in the early 1980s and has been extended numerous times. There are justifications for subsidies for research investments, given evidence that the social returns to this investment exceed the private returns, but the credit is criticized as being poorly targeted and subject to abuse.[25]

[25] CRS Report RL31181, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress*, by (name redacted).

Table A-2. Extenders that Primarily Affect Businesses: Revenue Cost of H.R. 3970's One-Year Extension

Provision	Revenue Effects FY2008-FY2017 ($billions)
Tax Credit for R&E Expenses	–8.998
Indian Employment Tax Credit	–0.059
New Markets Tax Credit	–1.322
50% Tax Credit for Railroad Track Maintenance	–0.165
15-Year Recovery Period, Leasehold and Restaurants	–3.466
7-Year Recovery Period Motorsports Racetrack Property	–0.027
Accelerated Depreciation, Indian Reservations	–0.148
Expensing "Brownfields" Remediation Costs	–0.192
Deduction for Domestic Production Puerto Rico	–0.116
Modify Unrelated Business Income Tax Treatment of Payments to Tax Exempt Organizations	–0.023
Extension of Qualified Zone Academy Bonds Benefits	–0.156
Tax Incentives for Investment in the District of Columbia	–0.158
Economic Development Credit for American Samoa	–0.016
Enhanced Charitable Deduction for Food Inventory	–0.072
Enhanced Charitable Deduction for Book Inventory	–0.031
Enhanced Charitable Deduction for Computers	–0.218
S Corporation Basis Adjustment for Charitable Contributions	–0.054

Source: Joint Committee on Taxation.

The second largest provision, measured by revenue loss, shortens to 15 years from 39 years the recovery period for improvements in real property made to accommodate lessors and restaurant improvements. These expenditures are likely to have shorter lives than industrial and commercial structures in general and there is some evidence that depreciation rules currently favor equipment over structures.[26] The third largest provision is the new markets credit, a provision targeted to lower-income areas.[27]

Other provisions costing at least $100 million include a tax credit for railroad track maintenance enacted in 2004 and designed to assist short line railroads; tax benefits for investments in Indian reservations and the District of Columbia, areas that targeted for economic development assistance; a provision allowing costs of cleaning up brownfields to be deducted immediately rather than over time as depreciation, a provision with an environmental objective; provisions allowing a tax credit for bonds used to financed certain special schools (zone academies)[28]; and a

[26] See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by (name redacted) and (name reda cted), which shows effective tax rates on equipment of about 25% while effective tax rates on commercial and industrial structures are in excess of 30%.

[27] See CRS Report RL34402, *New Markets Tax Credit: An Introduction*, by (name redacted).

[28] See CRS Report R40523, *Tax Credit Bonds: Overview and Analysis*, by (name redacted).

provision allowing a charitable deduction in excess of the basis of donated property to the firm (which is the cost or depreciated price) for computers. There are two other provisions that allow contributions in excess of basis: food inventory and for books. The enhanced food inventory provision for corporations is already a permanent part of the tax code; the temporary aspect of this food inventory provision is the extension of it to unincorporated businesses.[29]

Two provisions not included in the CRS summary of extenders are the provision to extend the production activities deduction to Puerto Rico (this provision is repealed after 2007 elsewhere in the bill and discussed previously), and a provision that limits the imposition of the unrelated business income tax to rents, royalties and other passive income received by tax exempt entities from controlled organizations.

Table A-3 summarizes other extenders that do not fall naturally into "individual" and "corporate" categories. Four of these provisions extend the authority to provide information to other government agencies to facilitate certain activities, and one extends IRS authority for undercover operations; these provisions have no revenue effect. A disclosure provisions relating to veterans raises a negligible amount. The other provision continues a temporary increase (from $10.50 per proof gallon to $13.50 per proof gallon) the payments made to Puerto Rico and the Virgin Islands to cover the U.S. excise taxes imposed on distilled spirits produced in those countries and imported into the United States.

Table A-3. Other Extenders: Revenue Cost of H.R. 3970's One-Year Extension

Provision	Revenue Effects FY2008-FY2017 ($billions)
Disclosure Provisions (tax return information to facilitate combines employment tax reporting; return and information to address terrorist activity, and return information to facilitate repayment of student loans); Authority for Undercover Operations	No Effect
Rum Excise Tax Payment to Puerto Rico and the Virgin Islands	-0.093
Disclosure Provision (tax information for veterans)	0.001

Source: Joint Committee on Taxation.

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[29] See CRS Report RL31097, *Charitable Contributions of Food Inventory: Proposals for Change*, by (name reda cted).

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