CTJ Citizens for Tax Justice

Revised February 4, 2013

Media contact: Anne Singer
(202) 299-1066 x27
www.ctj.org

Working Paper on Tax Reform Options

End Tax Sheltering of Investment Income and Corporate Profits and Limit Tax Breaks for the Wealthy

There are at least three major categories of tax reforms Congress could pursue to raise revenue. They include ending tax breaks and loopholes that allow wealthy individuals to shelter their investment income from taxation, ending breaks and loopholes that allow large, profitable corporations to shift their profits offshore to avoid U.S. taxes, and limiting the ability of wealthy individuals to use itemized deductions and exclusions to lower their taxes.

The first category of reforms would target what former Treasury Secretary Larry Summers recently called "the numerous exclusions from the definition of adjusted gross income that enable the accumulation of great wealth with the payment of little or no taxes."[1] It is unclear exactly how much revenue the Joint Committee on Taxation (JCT, the official revenue estimator for Congress) would estimate could be raised from these reforms. However, the figure would likely be in the hundreds of billions of dollars, based on JCT's estimates of certain proposals and tax expenditures.

Revenue Impacts of Reform Options Based on Methods of Joint Committee of Taxation (JCT) and Department of Treasury, 2014-2023

Proposal	10-Year Revenue Impact	
	Based on JCT scoring	Based on Treasury scoring
End tax shelters for investment income	not yet estimated; hundreds of billions	not yet estimated; hundreds of billions
Prevent offshore corporate tax avoidance		
strong version	$606 billion	not yet estimated;
weak version	$221 billion	$313 billion
Limit wealthy individuals' savings from deductions and exclusions	$513 billion	$583 billion

The second category of reforms would target U.S. multinational corporations that engage in convoluted transactions and accounting schemes to make what are truly U.S. profits appear to be generated in a country with no corporate tax or a very low corporate tax (a tax haven) in order to avoid the U.S. corporate tax. JCT has already estimated that the very strongest reform possible in this category (ending "deferral" of U.S. taxes on the offshore profits of U.S. corporations and reforming the foreign tax credit) would raise around $600 billion over a decade. The other reforms in this category are more modest reforms proposed by President Obama to limit the worst abuses of deferral (and would be unnecessary if deferral was eliminated). These include some proposals that the administration eventually dropped or weakened under pressure from multinational corporations. JCT is likely to estimate that the combination of these more modest

[1] Lawrence Summers, "A tax reform to cut complexity, increase fairness," *The Washington Post*, December 16, 2012. http://articles.washingtonpost.com/2012-12-16/opinions/35864243_1_tax-code-estate-tax-income

reforms (in their strongest incarnations) would raise around $221 billion over a decade, while the Treasury Department is likely to estimate that they would raise around $313 billion over a decade.

The third category of reform is embodied in the President's proposal to limit the tax savings from each dollar of certain deductions and exclusions to 28 cents. As this report explains, JCT is likely to estimate that this proposal would raise around $513 billion over a decade, but the Treasury Department is likely to estimate a higher number (based on past revenue estimates).

Three Categories of Tax Reforms Congress Can Pursue, Revenue Impacts 2014-2023
Revenue Impacts of Reform Options Based on Methods of Joint Committee of Taxation (JCT) and Department of Treasury

Proposal	10-Year Revenue Impact in Billions	
	Based on JCT scoring	Based on Treasury scoring
End Tax Shelters for Investment Income		
Tax capital gains at death	no estimate, but likely hundreds of billions	no estimate, but likely hundreds of billions
End deferral of tax on inside buidup of life insurance and annuities	+270.0	no estimate
End deferral of tax on like-kind exchanges	+27.9	no estimate
Limit value of IRAs or tax contributions that are grossly undervalued	no estimate	no estimate
Reform tax treatment of derivatives (including mark-to-market taxation)	no estimate	no estimate
Subtotal: end tax shelters for investment income tax base	incomplete estimates	incomplete estatimes
Strong Reforms to Prevent Offshore Corporate Tax Avoidance		
End deferral and reform foreign tax credit	+605.8	no estimate
Modest Reforms to Prevent Offshore Corporate Tax Avoidance		
Defer deduction of expenses, except R&E expenses, related to deferred income	+65.2	+79.5
Reform foreign tax credit: Determine the foreign tax credit on a pooling basis	+59.7	+63.1
Reform business entity classification rules for foreign entities	+41.2	+115.3
Tax currently excess returns associated with transfers of intangibles offshore	+20.8	+22.5
Disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates	+14.3	+2.6
Modify tax rules for dual capacity taxpayers	+10.0	+11.2
Prevent using leveraged distributions from related foreign corps. to avoid dividend treatment	+3.2	+3.4
Tax gain from the sale of a partnership interest on look-through basis	+2.5	+2.7
Limit earnings stripping by expatriated entities	+1.9	+4.6
Extend section 338(h)(16) to certain asset acquisitions	+1.0	+1.0
Prevent repatriation of earnings in certain cross-border reorganizations	+0.5	+0.4
Remove foreign taxes from a section 902 corp.'s foreign tax pool if earnings are eliminated	+0.4	+0.4
Limit shifting of income through intangible property transfers	+0.3	+6.3
Subtotal modest corporate tax reforms	+221.0	+313.0
Limit Wealthy Individuals' Savings from Deductions and Exclusions		
Limit the tax savings for each dollar of certain deductions and exclusions to 28¢	+513.0	+583.0

The revenue impacts of several proposals in this report have been estimated by both JCT and the Treasury Department for time periods beginning in past years. This report presents uses calculations to update the JCT and Treasury figures to show what the proposals are likely to raise over the 2014-2023 period. The figures for the President's proposed limit on deductions and exclusions are updated using the microsimulation tax model of the Institute on Taxation and Economic Policy, while other revenue figures are based on calculations that extend the revenue estimates of JCT and Treasury for previous time periods. In both cases, this report presents two sets of numbers, one to match the likely JCT estimate, and another to match the likely Treasury estimate, to account for the ways in which the two agencies have provided differing figures in the past.

1. End Tax Shelters for Investment Income

Former Treasury Secretary Lawrence Summers recently noted: "What's needed is an element that has largely been absent to date: [reducing] the numerous exclusions from the definition of adjusted gross income that enable the accumulation of great wealth with the payment of little or no taxes."[2] The following proposals could begin to achieve this.

Proposal: Tax capital gains at death.

Problem: Income that takes the form of capital gains on assets that are not sold during the owner's lifetime escape taxation entirely. The heirs of the assets enjoy a "stepped-up basis" in the assets, meaning that any accrued gains at the time the decedent died are never taxed. The estate tax once ensured that such gains would be subject to some taxation, but repeal of three-fourths of the estate tax has been made permanent in the fiscal cliff deal.

The justification for the stepped-up basis seems to be the difficulty in ascertaining the basis (the purchase price, generally) of an asset that a taxpayer held for many years before leaving it to his or her heirs at death.

But this difficulty (which is decreasing rapidly because of digital records) does not justify the sweeping rule allowing stepped up basis for all assets left to heirs — even assets that have a clearly a recorded value and assets that were only acquired right before death.

It is also not obvious that this difficultly with determining the basis is that different after the death of the owner of the asset. Consider an asset that was held for, say, 40 years and bequeathed at death and an asset that was held for 40 years and then sold to fund the taxpayer's retirement. In the former situation, the gains that accrued over those 40 years are never taxed, but in the latter situation they are taxed. But any difficulties in determining basis would seem to be the same in these situations.

Description of Proposal: The best approach, which would raise the most revenue, would be to simply tax capital gains that had never been realized during the owner's lifetime upon the death of the owner. The second-best approach would be to enact a "carry-over" basis, which means the heirs of the appreciated assets are not taxed immediately, but will eventually be taxed if the heirs sell the assets. This is a second-best approach because the heirs may not sell but instead enjoy the deferral of tax on the gains for years or until death.

10-Year Revenue Impact: Not estimated. The revenue saved could quite possibly exceed $500 billion. According to JCT, $258 billion will be lost over the 2013-2017 period because of the exclusion of capital gains at death.[3]

---

[2] Id.

[3] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017," February 1, 2013, JCS-1-13, page 34. https://www.jct.gov/publications.html?func=startdown&id=4503

Proposal: End deferral of tax on inside buildup of life insurance and annuities.

Problem: Normally, when people hold investments they must pay income taxes when interest or dividends are paid from those investments or when assets are sold resulting in capital gains income. However, people who buy annuities or "whole-life" insurance policies effectively defer such taxes because their premiums are used to make investments and the earnings on those investments (interest, dividends, capital gains) are not taxed as they accumulate. The benefit seems to go mainly to the well-off. Data from the Federal Reserve indicates that over half of this untaxed investment income is owned by the richest 10 percent of Americans, and very little is owned by the bottom half of Americans.[4]

Description of Proposal: One approach would simply make the investment earnings taxable as they accrue. In theory this could present problems because people would be required to pay tax on gains even though they have not received any cash income. Another approach would have the tax paid directly by the company providing the annuity or insurance policy.[5] The company would automatically collect a withholding tax except when a policy-holder opts to pay the tax directly.

10-Year Revenue Impact: $270 billion over ten years. This is based on a JCT estimate (cited by the Congressional Budget Office) updated by CTJ for the 2014-2023 period.[6]

Proposal: Eliminate, or strictly limit, deferral of tax on gains from like-kind exchanges.

Problem: Businesses can take tax deductions for purported depreciation on their properties, and then sell these properties at an appreciated price while avoiding capital gains tax, through what is known as a "like-kind exchange." This multi-billion-loophole, which was originally intended as a tax break for farmers trading acreage, has also been widely exploited by many giant companies, including General Electric, Cendant and Wells Fargo.[7]

In fact, the "tax expenditure report" of the Joint Committee on Taxation (JCT) shows that most of the revenue lost as a result of this tax expenditure actually goes to corporations, not individuals.

Description of Proposal: One approach is to simply eliminate deferral for all like-kind exchanges. Another is to limit such deferral to its original purpose — situations in which two farmers exchange land. This could be accomplished by setting a dollar limit on the amount of tax that can be deferred and limiting the number of times a taxpayer can use this tax break in a certain number of years. This would ensure that the break would continue to benefit anything

---

[4] Mark Maremont and Leslie Scism, "Shift to Wealthier Clientele Puts Life Insurers in a Bind," *Wall Street Journal*, October 3, 2010. http://online.wsj.com/article/SB10001424052748703435104575421411449555240.html

[5] Seth Hanlon and Jordan Eizenga, "Tax Expenditure of the Week: Tax-Free "Inside Buildup" of Life Insurance," Center for American Progress, March 30, 2011. http://www.americanprogress.org/issues/open-government/news/2011/03/30/9220/tax-expenditure-of-the-week-tax-free-inside-buildup-of-life-insurance/

[6] The Congressional Budget Office uses revenue estimates from JCT in its publications. The revenue estimate for this tax proposal, produced for an earlier ten-year period, is found in Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, page 155. http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12085/03-10-reducingthedeficit.pdf

[7] David Kocieniewski, "Major Companies Push the Limits of a Tax Break," *The New York Times*, January 6, 2013. http://www.nytimes.com/2013/01/07/business/economy/companies-exploit-tax-break-for-asset-exchanges-trial-evidence-shows.html?pagewanted=all&_r=0

resembling a family farm while sharply limiting it for large business interests and extremely wealthy individuals looking for tax avoidance opportunities.

10-Year Revenue Impact: $27.9 billion. This is based on a JCT estimate updated by CTJ for the 2014-2023 period.[8]

Proposal: Limit value of IRAs or tax contributions that turn out to be grossly undervalued.

Problem: Part of the problem is that current tax law allows leveraged-buyout partners such as Mitt Romney to misvalue assets and end up with $50 million or more in tax-free individual retirement accounts, grossly evading the official $5,000 annual contribution limit. Another part of the problem is simply that there is no need to provide a tax break for saving such vast sums of money. (Mitt Romney's IRA is reported to be worth $87 million.)[9]

Description of Proposal: One approach would be to require retroactive taxation of contributions to IRAs if the value of those contributions rises above some set percentage. Another approach would be to limit the value of an IRA. If an IRA is worth more than a certain amount, then a distribution would be required, and the income would thus be taxed.

10-Year Revenue Impact: Unknown. JCT estimates that the amount of revenue foregone as a result of IRAs and Roth IRAs will be $96.8 billion from 2013 through 2017, so their 10-year total cost probably exceeds $200 billion.[10] It is unclear what fraction of that revenue would be saved by blocking the type of IRA benefits obtained by Mitt Romney and others.

Proposal: Reform and make consistent the tax treatment of derivatives.

Problem: Current tax law treats "derivatives" — futures contracts, options, swaps, and so forth — in a variety of ways, none of them correct. This allows taxpayers to use derivatives to avoid or defer taxes on investment income.

A derivative can be thought of as a contract between two parties to make some sort of transaction and that has a value derived from the underlying asset involved in that transaction. For example, two people can enter into a contract that gives party A the right to buy stock from party B at a certain price in the future. If the price of the stock rises above that price, party A wins (he gets to buy the stock at less then its value) and party B loses (he has to sell the stock at less than its value). Conversely, if the stock value turns out to be less than the contract price, party B wins (and party A loses).

Derivatives can be useful financial tools for businesses, particularly for hedging risks. For example, a farm business may want to reduce risk by setting a future price for its crops at a

[8] The revenue estimate this proposal for an earlier time period (which CTJ updated to the 2014-2023 period for this report) is found in Joint Committee on Taxation, "Estimated Revenue Effects of Corporate Tax Reform Revenue Raising Provisions that Repeal or Modify Tax Expenditures," October 27, 2011, JCT-11-1-133.
[9] Tom Hamburger, "Mitt Romney Exited Bain with Rare Tax Benefits in Retirement," Washington Post, September 2, 2012 http://www.washingtonpost.com/politics/mitt-romney-exited-bain-capital-with-rare-tax-benefits-in-retirement/2012/09/02/1bddc8de-ec85-11e1-a80b-9f898562d010_print.html
[10] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017," February 1, 2013, JCS-1-13, page 40. https://www.jct.gov/publications.html?func=startdown&id=4503

certain level. So the farm agrees to sell the crops at a future date at that certain price. The buying party is betting that the value of the crops will be higher in the future. This "hedging" may or may not turn out to maximize the farm's profits, but the business can eliminate its downside risk.

In recent years, derivatives have become far more complex, particularly as they have become traded by individual and corporate investors who have no connection or interest in the underlying assets. For example, imagine that neither party in the contract described above actually owns or plans to buy the crops that the contract refers to. The contract really is just a bet by the two parties on which way the crops' value will move.

Derivatives can also create huge opportunities for tax avoidance. To take just one example, some high-profile people of enormous wealth, including Ronald S. Lauder, heir to the Estée Lauder fortune, have used a derivative called a "variable prepaid forward contract" to sell stock without paying taxes on the capital gains for a long time. Lauder entered into a contract to lend $72 million worth of stock to an investment bank and promised to sell the stock to the bank at a future date at a discounted price, in return for an immediate payment of cash.[11] The contract also hedged against any loss in the value of the stock. The contract put Lauder in a position that is economically the same as having sold the stock — he received cash for the stock and did not bear the risk of the stock losing value — and yet he does not have to pay tax on the capital gains until several years later, when the sale of the stock technically occurs under the contact.

Billy Joe "Red" McCombs, co-founder of Clear Channel and former owner several sports teams, used the same type of derivative, the "variable prepaid forward contract," to dodge capital gains taxes. He entered into a contract to lend an investment bank his Clear Channel stock for $292 million and officially sell the stock to the bank several years later. The IRS did decide that the contract was actually a sale, and that he owed $44.7 million in back taxes — but then settled for only half that amount.[12] Dole Food Co. Chairman David H. Murdock and former AIG chairman and CEO Maurice "Hank" Greenberg have both entered the same type of contracts for hundreds of millions of dollars.[13]

Description of Proposal: An intriguing proposal put forward by House Ways and Means Chairman Dave Camp (R-Mich.) would subject most derivatives to what is called "mark-to-market" taxation. At the end of each year, gains and losses from derivatives would be included in income, even if the derivatives were not sold. All profits (and losses) would be treated as "ordinary," meaning that they would be treated as regular income and would be ineligible for the special low tax rates on capital gains. The new rule would exempt those derivatives that are used for actual business hedging.

Assuming the mark-to-market system is implemented properly without loopholes or special exemptions for those with lobbying clout, the result would be that the types of tax dodges described above would no longer provide any benefit. The taxpayers would not bother to enter

---

[11] David Kocieniewski, "A Family's Billions, Artfully Sheltered," *New York Times*, November 26, 2011. http://www.nytimes.com/2011/11/27/business/estee-lauder-heirs-tax-strategies-typify-advantages-for-wealthy.html?_r=0&pagewanted=all

[12] Jesse Drucker, "Buffett-Ducking Billionaires Avoid Reporting Cash Gains to IRS," *Bloomberg*, November 21, 2011. http://www.bloomberg.com/news/2011-11-21/billionaires-duck-buffett-17-tax-target-avoiding-reporting-cash-to-irs.html

[13] Id.

into those contracts because they would be taxed at the end of the year on the value of the contracts (meaning they are unable to defer taxes on capital gains) and the gains would be taxed at ordinary income tax rates.

10-Year Revenue Impact: There is no revenue estimate for this proposal at this time, but experts believe it could raise substantial revenues from curbing tax avoidance. Unfortunately, Chairman Camp proposes to use the revenue savings from this and other loophole-closing provisions to offset reductions in tax rates, but there is no reason why Congress could not enact this reform as a way to raise revenue.

2. Prevent Offshore Corporate Tax Avoidance

The strongest proposal to reform the international corporate tax rules is to simply repeal the rule allowing U.S. corporations to "defer" paying U.S. taxes on their offshore profits, which could raise around $606 billion over a decade.[14]

A more modest alternative in this area would be to adopt the multinational corporate tax reforms proposed in President Obama's first four budget proposals. These 13 reforms, including ones that the administration proposed in 2009, but later weakened or abandoned, would increase revenues by about $313 billion over ten years, according to the Treasury Department's estimating methodology.[15]

Based on JCT's estimating methodology, these measures would raise less, $221 billion over ten years.[16] This is mainly because the JCT staff found technical problems with one of the administration's major reforms proposed in 2009 (curbing multinational abuses of "check-the-box").[17] If those technical problems are solved, then the JCT total estimate of the administration's 13 reforms would be roughly similar to the administration estimate.

Most of these 13 reforms limit the worst abuses of deferral in some way or another, and most would therefore be unnecessary if deferral was simply eliminated.

The following is a description of the strongest option in this category (ending deferral) as well as the most significant of the President's 13 more modest reform proposals in this area.

---

[14] Joint Committee on Taxation, "Estimated Revenue Effects of S. 3018, The 'Bipartisan Tax Fairness and Simplification Act of 2010,' " Nov. 2, 2010. The JCT estimate was for fiscal years 2011-20 ($583 billion); the $600 billion figure cited here has been extrapolated to fiscal 2014-23. http://www.wyden.senate.gov/download/joint-committee-on-taxation-estimated-score-of-the-bipartisan-tax-fairness-and-simplification-act-of-2010

[15] Obama budget proposals submitted in 2009-2012. The total in the text extrapolates these proposals to fiscal 2014-23.

[16] JCT analyses of the tax provisions in the Obama budgets, x-28-09, x-7-10r, x-19-11 and x-27-12.

[17] JCT, "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment," JSC-4-09, Sept 2009, pp. 106-115.

Proposal: End "deferral" of U.S. taxes on offshore profits of U.S. corporations.

Problem: 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).[18] 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) U.S. 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.

A new study by the Congressional Research Service found strong evidence of widespread corporate offshore profit shifting of this type.[19]

Description of Proposal: Corporations would pay U.S. taxes on their offshore profits as they are earned. 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 their profits 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.

---

[18] 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.")

[19] Congressional Research Service, "An Analysis of Where American Companies Report Profits: Indications of Profit Shifting," Jan. 18, 2013. CRS found that "significant shares of profits are being reported in tax preferred countries and that these shares are disproportionate to the location of the firm's business activity as indicated by where they hire workers and make investments. For example, American companies reported earning 43% of overseas profits in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland in 2008, while hiring 4% of their foreign workforce and making 7% of their foreign investments in those economies. In comparison, the traditional economies of Australia, Canada, Germany, Mexico and the United Kingdom accounted for 14% of American MNCs overseas' profits, but 40% of foreign hired labor and 34% of foreign investment. This report also shows that the discrepancy between where profits are reported and where hiring and investment occurs, as examples of business activity, has increased over time."

government. This is how the system is supposed to work now, with the huge exception that American corporations also can "defer" (not pay) their U.S. taxes entirely. The combination of deferral and the foreign tax credit creates huge opportunities for tax avoidance.

10-Year Revenue Impact: $606 billion.

The strongest version of this reform is a provision in the tax reform bill introduced in 2010 by Sen. Ron Wyden (D-Ore.) and then-Sen. Judd Gregg (R-N.H.) to "apply per-country foreign tax credit rules and include active income of controlled foreign corporations in Subpart F income." According to JCT, this would increase federal revenues by $583 billion over ten years.[20] Calculations by CTJ update this figure to $606 billion raised over the 2014-2023 period.

Another deferral reform proposal described in a recent CBO report is much weaker (apparently because it does not include the per-country foreign tax credit rules and perhaps for other technical reasons). It would raise just $114 billion over a decade.[21]

Modest Corporate Tax Reform Options (Short of Ending Deferral)

Revenue Impacts of International Reform Options Based on Methods of Joint Committee of Taxation (JCT and Department of Treasury, 2014-2023

Proposal	10-Year Revenue Impact in Billions	
	Based on JCT scoring	Based on Treasury scoring
Defer deduction of expenses, except R&E expenses, related to deferred income	+65.2	+79.5
Reform foreign tax credit: Determine the foreign tax credit on a pooling basis	+59.7	+63.1
Reform business entity classification rules for foreign entities	+41.2	+115.3
Tax currently excess returns associated with transfers of intangibles offshore	+20.8	+22.5
Disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates	+14.3	+2.6
Modify tax rules for dual capacity taxpayers	+10.0	+11.2
Prevent using leveraged distributions from related foreign corps. to avoid dividend treatment	+3.2	+3.4
Tax gain from the sale of a partnership interest on look-through basis	+2.5	+2.7
Limit earnings stripping by expatriated entities	+1.9	+4.6
Extend section 338(h)(16) to certain asset acquisitions	+1.0	+1.0
Prevent repatriation of earnings in certain cross-border reorganizations	+0.5	+0.4
Remove foreign taxes from a section 902 corp.'s foreign tax pool if earnings are eliminated	+0.4	+0.4
Limit shifting of income through intangible property transfers	+0.3	+6.3
TOTAL	+221.0	+313.0

Proposal: Eliminate or reform "check-the-box" rules.

Problem: One exception to the general rule allowing U.S. corporations to "defer" U.S. taxes on their foreign income applies when certain types of payments, like interest payments, are made to offshore subsidiaries of U.S. companies. Congress made a decision many years ago that it would be simply too easy to concoct tax avoidance schemes with this sort of "passive" income if deferral

[20] Joint Committee on Taxation, "Estimated Revenue Effects Of S. 3018, The 'Bipartisan Tax Fairness and Simplification Act of 2010,' " Nov. 2, 2010. The JCT estimate was for fiscal years 2011-20 ($583 billion); the $600 billion figure cited here has been extrapolated to fiscal 2014-23. http://www.wyden.senate.gov/download/joint-committee-on-taxation-estimated-score-of-the-bipartisan-tax-fairness-and-simplification-act-of-2010

[21] CBO's 2011 options report page 186 http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12085/03-10-reducingthedeficit.pdf

was not limited. Unfortunately, this limit was severely weakened in the mid-1990s with the adoption of the “check-the-box” rules. The President proposed in 2009 to reform the check-the-box rules but, sadly, dropped this proposal the following year.

In the late-1990s, the Treasury mistakenly thought it would be a good idea to eliminate litigation over what legal form a business should be treated as being for tax purposes (e.g., corporation, partnership, limited liability company). So Treasury issued a regulation allowing businesses to decide the matter on their own by simply checking a box on a form. Of course, simplification did result, in the sense that litigation always declines when the IRS simply stops pursuing a type of tax avoidance.

Imagine a multinational U.S. corporation owns an entity in Germany that makes an interest payment to a related entity that it also owns in, say, Lichtenstein. If the Lichtenstein entity is a branch of the German company, then the interest payment is an internal company payment, meaning the German may not deduct it as an expense to reduce the taxes it pays to the German government, but it also means that the U.S. does not recognize taxable income on the interest paid to the Lichtenstein entity. On the other hand, if the Lichtenstein entity is a subsidiary corporation (rather than a branch), then the German company may deduct the interest payment as a business expense (reducing the taxes it pays to Germany) but because the U.S. government recognizes the Lichtenstein entity as a subsidiary corporation, that payment is taxed by the U.S. as income. (The interest payment does not qualify for deferral because it is “passive” income.) Either way, the interest payment is income that is taxed somewhere.

Under the check-the-box rules, the interest payment may be taxed *nowhere*. In our example, Germany is told that the Lichtenstein entity is a subsidiary corporation and the payment made by to the Lichtenstein company is therefore deductible in Germany. But the U.S. government is told that the Lichtenstein entity is a branch of the German company, so the payment is an internal payment and there is no income to be taxed. In real life, this often involves U.S. profits that have been artificially shifted to the German company and then shifted to the Lichtenstein entity, thus allowing American corporations to avoid U.S. taxes on their U.S. profits.

Description of Proposal: The strongest and most sensible reform would be to completely repeal the check-the-box rules. In 2009, the Obama administration proposed a more modest step of reforming the rules to block this particular type of multinational corporate tax dodge. The administration dropped this reform from its revenue-raising proposals the following year, apparently under pressure from multinational corporations.

10-Year Revenue Impact: $41.2 billion based on JCT’s estimating methodology, $115.3 billion based on Treasury’s estimating methodology.

Proposal: Determine foreign tax credit on a “pooling” basis.

Problem: Individuals or companies with income generated abroad get a credit against their U.S. taxes for taxes paid to foreign governments, in order to prevent double-taxation. This makes sense in theory. But, unfortunately, corporations sometimes get foreign tax credits that exceed the U.S. taxes that apply to such income, meaning that the U.S. corporations are using foreign tax credits to reduce their U.S. taxes on their U.S. profits, not just avoiding double taxation on their foreign income.

For example, say a U.S. corporation owns two foreign subsidiaries, one in a country where it actually does business and pays taxes, the other in a tax haven where it does no real business and pays no taxes. The U.S. corporation has accumulated profits in both foreign subsidiaries. If the U.S. company decides to bring some of its foreign profits back to itself, it can say that the profits it has "repatriated" all came from the taxable foreign corporation, thereby maximizing its foreign tax credit that it can use to reduce its U.S. tax on the repatriation.

Description of Proposal: The President's proposal would require that the foreign tax credit be calculated on a consolidated basis, or "pooling basis." In our example, that means that the U.S. corporation must compute the foreign tax credit as if the dividend was paid proportionately from each of its foreign subsidiaries. Since no foreign tax was paid on the profits in the tax haven, this approach will reduce the U.S. company's foreign tax credit to the correct amount.

10-Year Revenue Impact: $59.7 billion based on JCT's estimating methodology, $63.1 billion based on Treasury's estimating methodology.

Proposal: Limit U.S. deductions for the interest expenses related to earning untaxed foreign profits.

Problem: U.S. multinational companies are allowed to "defer" the U.S. taxes on income generated by their foreign subsidiaries until that income is brought back to the U.S. ("repatriated"). There are numerous problems with deferral, but it's particularly problematic when a U.S. company defers U.S. taxes on foreign income even while it deducts the expenses of earning that foreign income to reduce its U.S. taxable profits.

Description of Proposal: To better protect the U.S. tax base on U.S. profits, the President's proposal would require that U.S. companies defer deductions for interest expenses related to earning income abroad until that income is subject to U.S. taxation (if ever).

The version of this proposal included in the President's first budget was stronger because it would have required that U.S. companies defer deductions for *all* expenses (other than research and experimentation expenses) relating to earning income abroad until that income is subject to U.S. taxation. The current proposal only applies to interest expenses.

10-Year Revenue Impact: $65.2 billion based on JCT's estimating methodology, $79.5 billion based on Treasury's estimating methodology.

Proposal: Tax currently excess returns associated with transfers of intangibles offshore.

Problem: U.S. multinational companies are allowed to "defer" the U.S. taxes on income generated by their foreign subsidiaries until that income is brought back to the U.S. ("repatriated"). If a multinational company can characterize some or all of its U.S. income as "foreign," it can reduce or even eliminate the U.S. taxes on that income.

Multinational corporations can often use intangible assets to make their U.S. income appear to be "foreign" income. For example, a U.S. corporation might transfer a patent for some product it

produces to its subsidiary in another country, say the Cayman Islands, that does not tax the income generated from this sort of asset. The U.S. parent corporation will then "pay" large fees to its subsidiary in the Cayman Islands for the use of this patent.

When it comes time to pay U.S. taxes, the U.S. parent company will claim that it's subsidiary made huge profits by charging for the use of the patent it holds, and that because those profits were allegedly earned in the Cayman Islands, U.S. taxes on those profits are deferrable (not due). Meanwhile, the parent company says that it made little or no profit because of the huge fees it had to pay to the subsidiary in the Cayman Islands (i.e., to itself).

Description of Proposal: The President proposes to reduce the incentives to engage in these abuses by ending the ability of U.S. corporations to defer their U.S. taxes on "excess income" from intangible property. There is already a category of income (including interest and other passive income) that U.S. corporations must pay U.S. taxes on even if it is generated offshore. This proposal would, reasonably, add "excess foreign income" from intangibles to that category.

10-Year Revenue Impact: $20.8 billion based on JCT's estimating methodology, $22.5 billion based on Treasury's methodology.

Proposal: Reform the rules for "dual capacity" taxpayers (primarily major oil companies).

Problem: 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. The U.S. tax code allows American corporations to take a credit for 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 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. This problem primarily involves U.S. multinational oil companies.

The problem began in the 1950s, when the U.S. wanted to ensure that American oil companies expanded their activities in Middle East oil countries. So at the insistence of the State Department, the IRS was forced to allow oil companies to treat the royalties they paid to Saudi Arabia and other oil-rich countries for oil as corporate income taxes. This was great for the oil companies, because it meant that those royalties were not just a tax deduction but a foreign tax credit, then worth twice as much as a deduction. (These days, a corporate tax credit is worth three times as much as a deduction.)

This loophole is supposed to be more limited now, but the limits are ineffective. The oil companies can arrange with a foreign government to impose a "tax" on an oil company — even though it doesn't impose corporate income taxes on any other type of company — and the oil company is allowed to "prove" that this "tax" is not a royalty by showing it's not a payment for a "specific economic benefit." But this is not credible on its face, because the economic benefit is obviously the right to extract the oil. Companies operating in a country without a tax on business income can use a safe harbor in the U.S. tax rules allowing them to treat a portion of their royalties as taxes without proving anything at all.

Description of Proposal: This proposal, which has been included in the President's budget plans and in his proposed jobs bill in 2011, would change the rules so that only foreign corporate income taxes that are applied generally to all types of companies will be creditable.

10-Year Revenue Impact: $10.0 billion based on JCT's estimating methodology, $11.2 based on Treasury's estimating methodology.

3. Limiting Wealthy Individuals' Tax Savings from Deductions and Exclusions

Proposal: Limit the tax savings of each dollar of certain deductions and exclusions to 28 cents.

Problem: Deductions and exclusions provide subsidies for certain activities (like buying a home or giving to charity) through the tax system. But they subsidize these activities at higher rates for wealthy families than they do for middle-income families. The President's proposal would reduce, but not eliminate, this unfairness.

The most prominent of the tax breaks targeted by this proposal are "itemized" deductions. People filing their federal income taxes are allowed deductions to lower their taxable income. They can either take a "standard deduction" or choose to "itemize" their deductions. Most people take the standard deduction, but better-off families typically itemize.

For example, the itemized deduction for home mortgage interest is supposed to encourage home ownership, but it provides more average dollar benefits to higher-income people. People rich enough to be in the 39.6 percent income tax bracket may save almost 40 cents for each dollar they can deduct in mortgage interest.[22] Middle-income families are generally in the 15 or 25 percent tax bracket. These families save only 15 cents or 25 cents for each dollar they deduct in mortgage interest.

If a member of Congress proposed a program to encourage home ownership through direct subsidies, with a larger percentage subsidies going to rich families than middle-income families, we would say that's absurd. But that's exactly how many deductions and exclusions work as subsidies.[23]

Description of Proposal: President Obama proposes to reduce, but not eliminate this unfairness, by allowing high-income people to save no more than 28 cents for each dollar of deductions and exclusions. This would limit the tax savings for people in the three income tax brackets above the 28 percent tax bracket (the 33, 35 and 39.6 percent brackets).

A provision in the proposal prevents it from having any effect on married couples with adjusted gross income (AGI) under $250,000 and single taxpayers with AGI under $200,000. (People with

---

[22] The mortgage interest deduction is limited to the interest on $1 million in mortgage debt, so high-income people may not be able to deduct all of their mortgage interest.

[23] On the other hand, some itemized deductions, such as the deduction for state and local taxes, can be defended as appropriate in determining taxpayers' ability to pay taxes. See Matthew Gardner, "How Tax Reform Can Help or Hurt State and Local Governments: Testimony Before the Senate Committee on Finance," Institute on Taxation and Economic Policy, April 25, 2012. http://itep.org/itep_reports/2012/04/how-federal-tax-reform-can-help-or-hurt-state-and-local-governments.php

AGI below these levels do not fall into the 35 percent of 39.6 percent tax brackets but can fall into the 33 percent bracket.)[24]

In 2011, the President expanded this proposal. It would limit not just itemized deductions but also certain "above-the-line" deductions, which are deductions that taxpayers are allowed to claim even if they use the standard deduction. The above-the-line deductions limited by this proposal include the deduction for health insurance for self-employed individuals, the deduction for domestic manufacturing (affecting certain individuals who own businesses), deductions related to moving expenses, student loan interest, health savings accounts and others.

The President's proposal would also limit certain tax exclusions. Exclusions provide the same sort of benefit as deductions, the only difference being that they are not counted as part of a taxpayer's income in the first place (and therefore do not need to be deducted). Just as with deductions, a dollar of income excluded will save a person in the top income tax bracket nearly 40 cents under current law, and 28 cents under the President's proposal.

The tax exclusions limited under this proposal are the exclusion for tax-exempt interest from state and local bonds, the exclusion for certain earnings of Americans overseas, and the exclusion for employer-provided health care.[25]

10-Year Revenue Impact: $513 billion based on JCT's estimating methodology, $583 billion based on Treasury's estimating methodology. The Institute on Taxation and Economic Policy (ITEP) microsimulation tax model was used to calculate these figures for the 2014-2023 period and reflect the fact JCT has estimated a smaller revenue gain from this proposal than the Treasury Department.

---

[24] When President Obama put forward his previous version of this proposal in 2009, some lawmakers expressed concern that it would hurt non-profits because it would reduce the tax subsidy for charitable donations by wealthy taxpayers. A report from the Center on Budget and Policy Priorities concluded that this proposal would only reduce charitable giving by around 1.9 percent. That's partly because only a small group of wealthy taxpayers are affected, and they only account for a fraction of the total charitable giving (about 17 percent) in the United States. Using previous studies on the way tax rates impact charitable giving, they estimated that this fraction of charitable giving will be reduced somewhat, but the overall impact on donations will be a reduction of only 1.9 percent. See Paul N. Van de Water, "Proposal to Cap Deductions for High-Income Households Would Reduce Charitable Contributions by Only 1.9 Percent," Center on Budget and Policy Priorities, revised March 31, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2700.

[25] Efforts to limit the exclusion for employer-provided health care during the health care debate were controversial. This proposal may be much less controversial because it is designed to raise taxes on only the richest Americans, whereas the proposals debated in 2009 and 2010 affected more taxpayers and targeted health plans because of their costs.