SUMMARIES OF REVENUE-RAISING PROVISIONS

I. <u>REVENUE DEDICATED TO DEFICIT REDUCTION</u>

INDIVIDUAL RATE INCREASES (IMPLICIT OR EXPLICIT)

Super Pease. The proposal reduces an individual taxpayer's tax savings from "tax expenditures" by five percent of the amount by which a taxpayer's adjusted gross income exceeds some threshold amount ($500,000 or $1 million). Tax expenditures would be defined generally by cross-reference to the Congressional Budget and Impoundment Control Act of 1974, which defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Regulations would be required to give guidance with respect to specific items. In general, tax savings from a special exclusion, exemption, or deduction are equal to the product of the gross amount of the item and the taxpayer's marginal rate; in the case of a credit, the tax savings are the amount of the credit; in the case of preferential rates, e.g., for capital gains, the tax savings are equal to the difference between the tax paid at preferential rates and the tax that would be paid if the income were taxed at the taxpayer's marginal rate; in the case of deferred items, a time value concept of money might be utilized to determine the value of deferral.

> *Discussion: Because high-income taxpayers typically enjoy a significant benefit from tax expenditures, staff believes that this proposal would have much the same effect as a surtax with the same threshold and rate.*
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> *Example 1: Assume the reduction is five percent of tax savings from tax expenditures for AGI over $500,000. Taxpayer has AGI of $600,000 and tax savings of $50,000. The taxpayer's tax savings would be reduced by five percent of $100,000, that is, $5,000. Notice that in this case the effect is identical to a five percent surtax on AGI in excess of $5,000.*
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> *Example 2: Assume the same facts as example one, except taxpayer has only $3,000 of tax savings. The taxpayer's tax savings would be reduced by $3,000. This example illustrates that there may be rare cases in which a very-high-income taxpayer who enjoys very little benefit from tax expenditures might pay less than such taxpayer would pay under a surtax.*
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> *Example 3: Assume the same facts as example one, except the taxpayer has AGI of only $501,000. The taxpayer's tax savings would be reduced by $50, that is, five percent of $1,000. This example illustrates that the proposal has no cliff effect; for taxpayers whose income exceeds the threshold by only a small amount, the additional burden will be correspondingly small.*

5.4 percent surcharge on families earning more than $1 million per year. Under this policy option, which passed the House as part of the House healthcare reform bill, a 5.4 percent surcharge would be imposed on modified adjusted gross income in excess of $1 million in the case of a joint return ($500,000 in the case of other taxpayers). No credits would be allowed against the tax and the tax would not be taken into account when calculating a taxpayer's alternative minimum tax liability.

> *Discussion: This proposal would bring the top marginal income tax rate on ordinary income to 40.4 percent for years before 2013, and to 48.8 percent in 2013 and afterwards (after taking into account the expiration of the 2001 and 2003 tax cuts and the 3.8 percent additional tax on unearned income). An income tax surcharge is scalable depending on the amount of revenue required; income thresholds, rates, effective date, indexing all can be modified.*

Repeal 2012 high-income tax cuts. The high-income tax cuts are scheduled to expire in 2013. Revenue could be raised against a current-law baseline by repealing the cuts for 2012.

FINANCIAL MARKETS/PRODUCTS

Ordinary income from day-to-day dealer activities. The proposal requires dealers in commodities, commodities derivatives dealers, dealers in securities, and dealers in options to treat income from their day-to-day dealer activities in certain traded derivatives contracts (section 1256 contracts) as ordinary income.

> *Discussion: Under present law, a taxpayer treated as a dealer in a particular type of property generally recognizes ordinary income from the sale or exchange of such property. Special rules apply to dealers in certain "section 1256 contracts" (a term that includes regulated futures contracts and certain options). Gain from the sale or exchange of these contracts by certain dealers is treated capital gain; 40 percent of such gain is treated as short-term gain and 60 percent is treated as long-term gain. As a result, some dealers in section 1256 contracts benefit from preferential long-term capital gain rates (60 percent of their gains are taxed at the 15 percent rate that applies to long-term capital gains). Other policy options in this area include a broader reform and rationalization of section 1256.*

Carried Interest. The proposal taxes income of service providers with respect to profits interests in certain investment partnerships as ordinary wage income. As such, this income would be subject to income tax at ordinary income rates and payroll taxes. The proposal is intended to apply to service providers in private equity, venture capital, real estate, and hedge fund partnerships who are compensated with profits interests in such partnerships. Only the income associated with services rendered to an investment partnership would be taxed at

ordinary income rates. The portion of any return on a profits interest received by a service provider with respect to an investment of capital by such service provider would be taxed as it is under present law (i.e., the character of the income will continue to be determined at the partnership level). As part of the Biden Group talks, the Administration and the Senate expressed an interest in scaling back the proposal so that it treats income recognized on the sale of a profits interest in an investment partnership that is attributable to goodwill as capital gain. This change was proposed in order to address the criticism that the original proposal imposed a punitive tax on goodwill at the time of a sale (the so-called "enterprise value" tax).

Discussion: Structures permissible under present-law partnership rules allow income earned from investment management services to be taxed in whole or in part at preferential capital gain rates (a maximum of 15 percent for long-term capital gains versus a maximum rate of 35 percent on ordinary income). Arguably, it is unfair to allow investment managers to take advantage of these preferential rates with respect to income from the labor involved in rendering investment management services while other labor income is taxed at ordinary income rates.

ESTATE AND GIFT TAXES

Consistent estate and gift value/income tax basis. Under present law, the basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death. That is, the basis is stepped up to fair-market value. Property included in a decedent's gross estate for estate tax purposes is also required to be valued at fair market value. Present law, however, does not explicitly require the basis of the property recipient for a particular item to be the same as the estate's basis for such item. Estates have an incentive to minimize "fair market value" while recipients have an incentive to inflate it. The proposal would impose a consistency requirement.

Discussion: imposing a consistency requirement is both fair and logical.

Require minimum term for GRATs. The proposal requires GRATs to have a minimum term of ten years and the remainder interest in a GRAT to be greater than zero.

Discussion: A grantor-retained annuity trust (GRAT) is a gift/estate tax planning device that can be used to transfer assets that are expected to appreciate at a rate that exceeds a statutory rate (120 percent of the Federal midterm rate) with few estate tax consequences. The planning technique does not provide its maximum benefit, however, if the grantor of the trust dies during the term of the retained annuity. (If the grantor dies during the term of the annuity, the value of the trust assets is included in his gross estate.) To minimize this risk, planners set up GRATs with very short terms (two years). The proposal mandates a minimum ten year term in order to enhance the downside risk

associated with the planning technique. It also requires the trust to have some remainder value so that tax cannot be avoided entirely.

Modify rules on valuation discounts. In general, the proposal creates a category of restrictions ("disregarded restrictions") that are ignored for purposes of valuing an interest in a family controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor or the transferee's family. Disregarded restrictions would include, for example, limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be defined in regulations.

Discussion: planners can create restrictions on interests in family-controlled entities that, while easily removed, may still be taken into account for valuation purposes. These restrictions, to the extent they depress the value of an interest, reduce gift and estate taxes. The proposal would ignore these artificial restrictions for purposes of valuing the interests subject to them.

Revert to 2009 estate tax parameters for 2012. Estate tax parameters are scheduled to revert to 2009 levels in 2013. Revenue could be raised against a current-law baseline by reverting to 2009 levels one year early (in 2012).

OTHER MISCELLANEOUS REVENUE ITEMS

Ensuring collection of employment taxes earned by certain service professionals (S corporation reasonable compensation). Social Security taxes are imposed on compensation and self-employment income up to the Social Security Wage Base (currently $106,800) and the Medicare tax is imposed on all self-employment and compensation income. Some service professionals have been avoiding Medicare and Social Security taxes by routing their self-employment income through an S corporation. These taxpayers pay themselves a nominal salary and take the position that the remaining earnings, paid to them in the form of dividends by the S corporation, are exempt from employment taxes. The proposal would address this abuse in situations where (1) an S corporation is engaged in a professional service business that is principally based on the reputation and skill of three or fewer individuals or (2) an S corporation that is a partner in a professional service business. The proposal would also clarify that individuals that are engaged in professional service businesses are unable to avoid employment taxes by routing their earnings through a limited liability corporation or a limited partnership.

Discussion: This provision would ensure that certain professionals who attempt to avoid their fair share of employment taxes by manipulating their form of business are held accountable for paying their fair share.

End Special Depreciation for Corporate Jets. Business jets currently are depreciated over five years, while commercial aircraft are depreciated over a longer period (seven years). The proposal would change the recovery period for business jets to that of commercial jets.

> *Discussion: There is a good policy rationale for making this change because there is no reason that jets used for different purposes (general vs. commercial aviation) should have different class lives.*

Reclaim Passport if Back Taxes Exceed $100,000. Currently the Federal government revokes passports and denies the issuance of new passports to individuals who owe more than $2,500 in child support payments. This proposal would authorize the government to deny the application for a new passport or renewal of an existing passport when the individual has $100,000 or more (indexed for inflation) of unpaid federal taxes which the IRS is collecting through enforcement action. It would also permit the Federal government to revoke a passport upon reentry into the United States for such individuals.

> *Discussion: A recent GAO study found that over 224,000 individuals that were issued passports owed over $5.8 billion in unpaid federal taxes as of 2008. This proposal could generate substantial collections of the billions of dollars in known unpaid federal taxes with little corresponding increase in IRS enforcement spending. By identifying tax offenders, this proposal would promote broader compliance with U.S. tax laws because it gives taxpayers more confidence that others are paying their fair share.*

II. REVENUE DEDICATED TO MAKE IT IN AMERICA RATE

REFORM U.S. INTERNATIONAL TAX SYSTEM

Tax on excess returns from intangibles. The proposal provides that if a U.S. person transfers (directly or indirectly) an intangible from the United States to a related controlled-foreign corporation, then certain "excess income" from transactions connected with or benefiting from the intangible would lose the benefit of deferral if the income is subject to a low foreign effective tax rate. The "excess income" subject to tax is the excess of gross income from transactions connected with or benefitting from the intangible over costs (excluding interest and taxes) properly allocated to the intangible plus a mark up (drafts have defined excess income as gross income exceeding 150 percent of allocable costs). Drafts also have proposed an exception for income subject to tax at a ten percent (or higher) effective rate.

> *Discussion: The Administration argues that "there is evidence that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base." Ending deferral of excess returns associated with*

intangibles transferred to affiliates in low-tax jurisdictions would "reduce the incentive for taxpayers to engage in these transactions."

Limit income shifting through transfers of intangible property. The proposal clarifies the scope of intangible property subject to the rule under section 367 (the "toll charge" on outbound transfers of property in reorganizations) and section 482 (the transfer pricing rules). Under the proposal, intangible property for the purposes of these rules would include workforce in place, goodwill, and going concern value.

Discussion: the Administration maintains that the lack of clarity with respect to present-law definitions may result "in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons."

Limit deduction for reinsurance premiums. There are various versions of this proposal. In general, all of the proposals would deny an insurance company a deduction for reinsurance premiums paid to affiliated foreign reinsurance companies to the extent the foreign reinsurer is not subject to U.S. tax. In addition, some versions of the proposal exclude from the U.S. insurer's income any ceding commissions received or reinsurance recovered with respect reinsurance policies for which a premium deduction was wholly or partially denied. Without this exclusion, the proposal is effectively a tax on gross premium income.

Discussion: the proposal reduces the incentive for foreign-owned domestic insurance companies to reinsure U.S. risks with foreign affiliates. Opponents of the proposition argue that it would increase costs for U.S. persons who purchase insurance from these foreign-owned domestic insurance companies.

Defer the deduction of interest expense related to deferred income. The proposal defers the deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax. Deferred interest expenses would become deductible when the previously deferred foreign-source income became subject to U.S. tax.

Discussion: present-law rules permit the deferral of certain foreign-source income without limiting the deductibility of interest expense incurred to earn such income. As a result, taxpayers have an incentive to borrow in the United States (reducing their U.S. taxes by the amount of the interest deduction) while investing overseas. The proposal would limit this incentive for debt-financed foreign investment.

Limitation on treaty benefits for certain deductible payments (treaty shopping). The bill would prevent foreign multinational corporations incorporated in tax haven countries from avoiding tax on income earned in the United States by routing their income through structures in which a United States subsidiary of the foreign multinational corporation makes a deductible payment to a country with which the United States has a tax treaty before ultimately sending these earnings to the tax haven country. This proposal includes provisions to ensure that foreign

multinational corporations incorporated in treaty partner countries will not be affected by this provision.

Discussion: This policy is generally consistent with the policy of so-called "limitation on benefits" provisions in certain bilateral tax treaties.

ENERGY AND ENVIRONMENT

Eliminate Fossil Fuel Preferences (for big 5 oil companies)

*****Repeal deduction for intangible drilling costs.** Under current law, the Code provides special rules that allow oil companies to either expense or capitalize intangible drilling and development costs (IDCs). IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling supplies, etc., incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Taxpayers may elect to deduct the amount of the IDC as an expense in the taxable year the cost is paid (generally, non-energy companies must capitalize these costs and recover them over time). The deduction for IDCs applies only to those IDCs associated with domestic properties. The provision would repeal the deduction for IDCs for the big 5 integrated oil companies.

Discussion: The expensing of IDCs, like other oil and gas preferences proposed for repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. The pricing distortions resulting from tax subsidies for the oil and gas industry are detrimental to long-term energy security and inconsistent with Democratic efforts to support a clean energy economy. Finally, tax subsidies for the oil and gas industry can create underinvestment in other, potentially more productive areas of the economy.

*****Repeal section 199 manufacturing deduction for oil and gas activities.** Under current law, section 199 of the Code provides a deduction from taxable income that is equal to a portion of the lesser of a taxpayer's taxable income or its qualified production activities income (in this case, "oil related qualified production activities income"). The section 199 deduction was enacted as a replacement to a domestic tax benefit that was found to violate World Trade Organization subsidy rules. The oil and gas industry did not receive the previous tax benefit, but it is eligible for the replacement benefit. "Oil-related qualified production activities income" includes the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. The provision would repeal the section 199 manufacturing deduction for the big 5 integrated oil companies.

Discussion: The section 199 manufacturing deduction, like other oil and gas preferences proposed for repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. The pricing distortions resulting from tax subsidies for the oil and gas industry are detrimental to long-term energy security

and inconsistent with Democratic efforts to support a clean energy economy. Finally, tax subsidies for the oil and gas industry can create underinvestment in other, potentially more productive areas of the economy.

***Repeal last-in-first-out accounting rules.** Taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer. One method of accounting for inventory-related income is the last-in-first-out accounting method. Under the LIFO method, it is assumed that the last items entered into the inventory are the first items sold. Taxpayers with increasing inventory costs can thus use the method to claim a higher value for cost of goods sold, resulting in lower income and reduced taxes. Additionally, international accounting standards indicate a shift to phase-out the LIFO accounting method in favor of accounting methods that would more accurately reflect the value of the total inventory. The provision would repeal the LIFO accounting method for the big 5 integrated oil companies.

Discussion: Repealing the LIFO method of accounting for large oil and gas companies would more accurately reflect the value of an oil and gas company's inventory and follows the general international accounting standards' path of LIFO repeal. The pricing distortions that result from using the LIFO method of accounting are detrimental to long-term energy security and inconsistent with Democratic efforts to support a clean-energy economy. Finally, tax subsidies for the oil and gas industry can create underinvestment in other, potentially more productive areas of the economy.

OTHER

Disallowance of depreciation in excess of alternative depreciation (ADS). The proposal would repeal modified accelerated cost recovery (MACRS) and put taxpayer on alternative depreciation (ADS).