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Business Tax Issues in 2007

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Summary

In recent years, business tax legislation has tended to focus on broad, structural issues and economic performance in general. For example, the 2003 tax cuts for capital gains and dividends were, in part, an incremental movement towards eliminating the double-taxation of corporate income that is a structural feature of the current U.S. business tax system. Also, these and other business tax cuts — for example, temporary "bonus" depreciation — were designed to provide a fiscal stimulus to spur an economy that remained sluggish after the 2001 recession. And in 2004, Congress enacted a set of business tax cuts that were generally aimed at boosting U.S. competitiveness through their impact on international trade and investment.

Early indications are that consideration of business tax policy in 2007 may focus on more narrow, sector-specific issues. And while overall economic performance is always of concern to tax policymakers — particularly in the area of business taxation — in early 2007 interest in business tax issues also appears to be driven by concerns about tax equity and by a search for tax revenue that would help reduce the federal budget deficit or offset tax cuts elsewhere. For example, energy taxation is being explored as a way to raise revenue as well as a means to stimulate investment in energy conservation and technology. Also, there appears to be considerable interest in restricting corporate tax shelters. Both Congress and the Administration have evinced an interest in tax cuts for small business — cuts that some view as a way to counter the impact of minimum wage increases on small business. In February, both the House and Senate approved bills containing small business tax benefits (an amended version of H.R. 2 in the Senate, and H.R. 976 in the House). And there are some indications that Congress may consider legislation that would make the research and development tax credit a permanent rather than temporary part of the tax code.

This report will be updated as legislative events occur.

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Business Tax Issues in 2007

The business tax legislation enacted in recent years has tended to have as its basis concern for broad economic performance. For example, the 2003 tax cuts for dividends and capital gains were an incremental step towards a basic structural reform of the tax system termed "tax integration," designed to restrict the double-taxation of corporate-source income. Also, the "bonus depreciation" and other business tax cuts enacted in 2003 and afterwards were partly intended to provide a broad fiscal stimulus to spur an economy that remained sluggish after the 2001 recession. And in 2004, Congress enacted an omnibus business tax bill (the American Jobs Creation Act; P.L. 108-357) that had U.S. business operations in the international economy as its principal focus.

Early indications are that business tax considerations in 2007 may focus on more narrow, sector-specific issues rather than broad, structural concerns. For example, in the year's first months, both the House and Senate began consideration of small-business taxation, while in January the House passed H.R. 6, a bill restricting certain tax benefits for petroleum companies. And while a concern for economic performance is still likely to be at the root of interest in business tax issues, their consideration may also be driven by concerns about tax equity and by a search for tax revenue. This report discusses what appear to be the most prominent business tax issues at the outset of 2007: energy taxation, small business taxes, the research and experimentation tax credit and other temporary tax benefits, corporate tax shelters, and international taxation. In order to place these issues in context, however, the report begins with a view of the current system's basic structure, and with a broad look at recent business tax legislation.

The Current System

The United States has what tax analysts sometimes term a "classical" system for taxing corporate income. That is, it imposes a tax on corporate profits — the corporate income tax — that is separate and generally in addition to the individual income taxes that corporate stockholders pay on their corporate-source capital gains and dividends. The corporate income tax applies a 35% rate to most corporate taxable income, although reduced rates ranging from 15% to 34% apply to corporations earning smaller amounts of income. The base of the tax is corporate profits as defined by the tax code — generally gross revenue minus interest, wages, the cost of purchased inputs, and an allowance for depreciation.

Over the past several decades — that is, since 1980 — federal corporate tax revenue has generally varied between 1% and just over 2% of gross domestic product (GDP). Congressional Budget Office (CBO) data show that corporate tax receipts registered an "uptick" in fiscal years (FY) 2005 and 2006, rising to 2.3% and 2.7% of GDP, respectively — an increase CBO attributed primarily to strong economic

growth. However, CBO also projects corporate tax revenue to recede in future years to a level closer to its long-term average.[1] In FY2006, corporate taxes comprised 14.7% of total federal revenues, third place behind individual income taxes (43.4%) and social security taxes (34.8%).[2]

Not all businesses are subject to the corporate income tax. Income earned by partnerships is "passed through" and taxed to the individual partners under the individual income tax without imposition of a separate level of tax at the partnership level. Also, businesses that have no more than 100 stockholders and that meet certain other requirements ("S" corporations), as well as certain other "pass through entities" are not subject to the corporate income tax, but are taxed in the same manner as partnerships.

Recent Legislation and Issues

The major tax cuts enacted in 2001 and 2003 with the Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA; P.L. 108-27), respectively, focused more on individual income taxes than corporate taxes, and included measures such as reductions in statutory tax rates, tax cuts for married couples, and expansion of the child tax credit. However, JGTRRA contained a number of tax cuts aimed at businesses, as did legislation enacted in 2002, 2004, and 2006.

The most prominent business tax cuts are described in this report's final section on an act-by-act basis, but we summarize them here in broad terms: temporary "bonus" depreciation provisions (now expired) designed to spur investment spending; capital gains and dividend reductions, intended (in part) to increase capital formation and the flow of savings to the corporate sector; extension of a set of narrowly-applicable temporary tax benefits (the "extenders") that were addressed by several acts, and provisions enacted in 2004 designed to boost U.S. manufacturing and competitiveness (the domestic production deduction and foreign tax credit provisions).

The policy questions the business tax legislation raised and that were debated — again, in broadest terms — were as follows:

- What would be the impact of the investment incentives on the economy's capital stock? Does the reduced tax burden increase the supply of capital and saving, thus increasing long-run growth? Or is the economy's supply of capital relatively fixed, meaning the investment incentives simply interfere with the efficient allocation of investment?

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[1] U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008-2017* (Washington: GPO, 2007), p. 81. Available at the CBO website, at [http://www.cbo.gov/publications/bysubject.cfm?cat=0].

[2] Ibid., p. 1.

- Were the enacted business tax cuts effective in stimulating the economy in the short run, thus aiding recovery from the 2001 recession? Or do planning lags and other factors make business tax cuts ineffective as a fiscal stimulus, meaning the relation between the business tax cuts and economic recovery was serendipitous?

- What was the effect of the business tax cuts on the overall fairness of the tax system? Did the reductions accrue primarily to relatively high-income stockholders and corporate creditors, or were any reductions on tax progressivity outweighed by positive employment effects?

- How did the business tax cuts affect U.S. economic competitiveness? Have provisions such as the domestic production deduction helped revitalize domestic manufacturing, or does the deduction and other competitiveness provisions interfere with the efficient and flexible participation of U.S. businesses in the world economy?

For more detailed discussion of these broad analytical issues, interested readers are referred to CRS Report RL31824, *Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market*, by Jane G. Gravelle; CRS Report RL32502, *What Effect Have the Recent Tax Cuts Had on the Economy?* by Marc Labonte; CRS Report RL32517, *Distributional Effects of Taxes on Corporate Profits, Investment Income, and Estates*, by Jane G. Gravelle; and CRS Report RS22445, *Taxes and International Competitiveness*, by David L. Brumbaugh.

We turn now, however, to more specific current issues.

Current Issues

Research and Experimentation Tax Credit and Other Temporary Benefits

The tax code contains a set of relatively narrowly applicable tax benefits (the "extenders") that are temporary in nature — they each were enacted for only fixed periods of time, and are each scheduled to expire on various dates. The benefits tend to be tax incentives: provisions designed to encourage certain types of investment or activity thought to be economically or socially desirable. As targeted tax incentives, the benefits tend to raise a similar policy question, as follows: according to traditional economic theory, smoothly functioning markets and undistorted prices generally allocate the economy's scare resources in the most efficient way possible. Absent market malfunctions — failures that economists believe are more the exception than the rule — economic theory indicates that tax benefits or penalties that interfere with the market reduce economic efficiency and reduce economic welfare. The question with each extender, then, is whether there is a market failure or socially desirable goal that makes the incentive's intervention in the market desirable.

One extender is the research and experimentation (R&E) tax credit, which was first enacted in 1981, and which has been scheduled to expire, but which has been renewed on numerous occasions. The credit provides businesses a tax benefit that is linked to the firms' increase in research outlays in the current year over a statutorily defined base period. The credit is based on economic theory's notion that free markets do not operate smoothly in the case of research and development — that absent government support, firms would not spend as much on research as is economically efficient. (It could also be argued, however, that the amount of support provided by the R&E credit and several other extant research subsidies more than compensate for the theoretical shortfall in research.)

The R&E credit's most recent extension was provided by the Tax Relief and Health Care Act of 2006 (TRHCA; P.L. 109-432) in December 2006, and it is currently scheduled to expire at the end of 2007; the extension included an additional, alternative method that firms can use to calculate the credit, which may result in additional tax savings for firms in certain circumstances. There has been interest in the current Congress, however, in making the tax credit permanent.

The extenders in general have been a continuing issue for Congress — in part because their temporary nature necessitates period action if they are not to expire, and in part because of the strong support for many of the benefits. Thus, while TRHCA extended many of the provisions in addition to the R&E credit, they may also receive consideration in 2007.[3]

Energy Taxation

Democratic leaders have stated that energy taxation is an issue they intend to address early in the new Congress. Their focus appears to be twofold: a revenue-raising scaling-back of several tax cuts for petroleum firms that were enacted in recent years and enactment of a new set of incentives aimed at energy conservation and promotion of alternative energy sources. On January 18, the House passed H.R. 6, containing restrictions on several tax benefits for the petroleum industry.

One of the revenue-raising items in H.R. 6 denies the tax code's Section 199 domestic production deduction to oil- and gas-related income.[4] The deduction was first enacted with the American Jobs Creation Act of 2004 (P.L. 108-357) and applies to the domestic U.S. manufacturing, extractive, and agriculture industries in general, not just to the petroleum industry. The deduction is phased in, with a rate equal to 6% of domestic production income in 2007-2009, and a permanent rate of 9% in 2010 and thereafter.

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[3] For a list of extenders addressed by TRHCA, see CRS Report RL33768, *Major Tax Issues in the 110th Congress*, by David L. Brumbaugh.

[4] Wesley Elmore, "Democrats Outline Early Agenda for 110th Congress," *Tax Notes*, Jan. 8, 2007; Kurt Ritterpusch, "Early Components in Democrats' Oil Industry Rollback Plan Firm Up," BNA *Daily Tax Report*, Jan. 5, 2006.

A second revenue-raising provision in H.R. 6 is modification of the amortization rules[5] applying to geological and geophysical (G&G) costs that integrated oil companies undertake. The Energy Policy Act of 2005 (EPACT05; P.L. 109-58) initially provided a tax benefit for oil and gas exploration and development by permitting two-year amortization of G&G costs. Economic theory indicates that, to measure income accurately, outlays that help create oil wells and other assets having value should be deducted only as the assets lose their worth. In the case of profitable wells, two-year amortization likely provided favorable treatment similar to accelerated depreciation. Initially, EPCT05's treatment applied to both integrated producers (i.e., large companies) and independent producers. The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA; P.L. 109-222) lengthened the amortization period to five years for integrated producers. H.R. 6 further lengthened the amortization period to seven years for integrated producers.

There are indications that at least part of the revenue produced by cutting energy tax benefits may be used to offset the revenue loss from expanded tax incentives to develop renewable and alternative energy sources — for example, hydropower, biofuel and ethonol, nuclear power, geothermal power, and solar energy.[6]

For a more detailed overview of energy tax policy, see CRS Report RL33578, *Energy Tax Policy: History and Current Issues*, by Salvatore Lazzari; and CRS Report RL33763, *Oil and Gas Subsidies: Current Status and Analysis,* by Salvatore Lazzari.

Small Business Taxation

Congress has had a long-standing interest in tax policy towards small business, and the first weeks of the 110th Congress have continued that pattern. Congressional action on small business taxation has occurred in conjunction with federal minimum wage legislation. The President and others have argued that an increase in the federal minimum wage — an issue considered early in the 110th Congress — should be coupled with consideration of tax cuts for small business. The tax cuts are viewed by their proponents as a means of offsetting the extra cost burden a higher minimum wage may place on small businesses. Tax provisions were not included in the House-passed bill increasing the minimum wage (H.R. 2). However, on February 1, the Senate approved an amended version of H.R. 2 that included a package of tax benefits for small business and a set of revenue-raising measures designed to offset part of the revenue loss expected from the tax benefits. The House subsequently approved a tax bill (H.R. 976; approved on February 16) containing a set of small business tax benefits more modest in size than the Senate's.

One prominent provision of the Senate bill is an extension of the "expensing" tax benefit for investment in machines and equipment — a tax benefit that applies only to firms undertaking less than a certain level of investment, and that therefore

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[5] Rules for gradually deducting ("amortizing") an item of cost or expense.

[6] Steven Mufson, "Democrats Hope to Take from Oil, Give to Green Energy, *The Washington Post*, Jan. 4, 2007, p. A01; Kurt Ritterpusch, "Baucus Says Subcommittee on Energy Could be Added to Finance Committee," BNA *Daily Tax Report*, Jan. 8, 2007.

generally favors small business. The provision is a tax benefit in that it permits firms to "expense" (deduct in the first year of service) a capped amount of investment outlays rather than requiring the outlays to be deducted gradually in the form of depreciation, as is required of most tangible investments. Permanent provisions of the Internal Revenue Code cap the expensing allowance at $25,000 per year, and begin a phase-out of the allowance when a firm's investment exceeds $200,000.[7] However, temporary rules initially enacted in 2003 and extended on several occasions increased the annual cap and threshold to $100,000 and $400,000, respectively. The increased amounts are indexed for inflation occurring after 2003; the 2007 amounts for the cap and threshold are $112,000 and $450,000. TIPRA provided the most recent extension in 2006, and extended the increased allowance and threshold through 2009. The Senate bill provides a one-year extension, through 2010.

Another provision of the Senate minimum wage bill would liberalize current restrictions on the use of cash accounting — a simplified and sometimes more generous method of accounting that is currently only available for firms having average annual gross receipts not exceeding $5 million in all prior years. The bill would generally increase the eligibility cap to $10 million of average annual gross receipts.

Other tax benefits in the Senate bill include liberalized depreciation rules for leasehold and restaurant improvements and for new restaurants, an extension of the temporary work opportunity tax credit (WOTC) for employers of individuals in certain "high risk" groups, and more generous rules for Subchapter S corporations (closely-held corporations not subject to the corporate income tax).

The revenue-raising offsets in the Senate version of H.R. 2 are generally narrowly focused provisions designed to restrict a number of types of tax-saving transactions or actions. The two largest provisions (in terms of revenue gain) would generate tax revenue by applying earlier effective dates to restrictions first implemented by the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357), thus applying the restrictions to more of the tax-saving transactions in question. One provision applies AJCA's restrictions to leasing transactions involving foreign entities; a second applies to corporate "inversion" or "expatriation" transactions — corporate reorganizations designed to shift titular ownership of U.S. corporate groups to offshore entities in tax havens.

Like the Senate bill, the measure approved by the House on February 16 (H.R. 976) proposes to extend the increased Section 179 expensing allowance through 2010, but the House bill also would further increase the allowance and phase-out threshold, to $125,000 and $500,000, respectively, and index those amounts for inflation occurring after 2007. The House bill would also, like the Senate measure, extend the WOTC, but for a shorter period: through 2008.

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[7] The cap is reduced on a dollar-for-dollar basis by each dollar of investment exceeding $200,000. Thus, firms undertaking investment in excess of $225,000 cannot claim the allowance under the permanent rules.

In contrast to the Senate bill, H.R. 976 contains no provisions for leaseholds and restaurants, nor Subchapter S provisions. The House bill also contains several benefits not in the Senate bill. One inclusion prevents, in effect, an increase in the minimum wage (should it occur) from reducing the tax credit employers currently receive for social security (FICA) taxes they pay on tips that exceed the minimum wage. A second provision expands the FICA/tip tax credit and the WOTC so that they can offset a firm's alternative minimum tax.

H.R. 976 contains fewer revenue-raising items than the Senate bill. The largest would deny reduced capital gains and dividend rates to dependents under the age of 24 who do not provide more than half their own support with earned income. (The bill also includes a measure that would shift the timing of estimated corporate tax payments, resulting in a revenue gain FY2012 but a corresponding loss in FY2013. The shift would thus be revenue neutral over those two years.)

Tax Shelters

An additional area in which Congress may look for tax revenues is corporate "tax shelters" — phenomena that also concern policymakers because of their corrosive effect on tax equity and popular perceptions about the tax system's fairness. In popular usage, the term "tax shelter" denotes the use of tax deductions or credits produced by one activity to reduce taxes on another: the first activity "shelters" the second from tax. In economic terms, a tax shelter can be defined as a transaction (for example, an investment or sale) that reduces taxes without resulting in a reduced return or increased risk for the participant.[8] But the term is so vague and general in most usages that it could also be defined simply as a tax saving activity that is viewed as undesirable by the observer using the term. Under most definitions, tax shelters can be either illegal and constitute "tax evasion" or legal, comprising "tax avoidance."

Congress has evinced considerable interest in tax shelters in recent years, and has enacted some restrictions into law. The American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) contained a number of provisions designed to restrict tax shelters. In part, the act's provisions were directed at specific tax shelters — for example, leasing activities and the acquisition of losses for tax purposes ("built in" losses). In addition, the act included provisions — for example, revised penalties and reporting requirements — designed to restrict sheltering activity in general.[9] In 2006, the Senate version of TIPRA contained a number of tax shelter restrictions, but the provisions were not included in the conference committee bill.

The Senate's TIPRA provisions included what the bill termed a "clarification" of the economic substance doctrine that has been followed in a number of court decisions applying to tax shelters. Generally, the economic substance doctrine

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[8] These definitions are taken from Joseph J. Cordes and Harvey Galper, "Tax Shelter Activity: Lessons from Twenty Years of Evidence," *National Tax Journal*, vol. 38, Sept., 1985, pp. 305, 307.

[9] For a list and description, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals Considered in the 108th Congress*, by Jane G. Gravelle.

disallows tax deductions, credits, or similar benefits in the case of transactions not having economic substance. The Senate version of TIPRA would have integrated aspects of the doctrine into the tax code itself. A similar measure was contained in the Senate version of the AJCA, but was not adopted, and given the relatively large revenue estimates associated with the measure — the Joint Tax Committee estimated that the Senate's 2006 provision would increase revenue by $15.8 billion over 10 years — it is possible that the economic substance doctrine will again receive congressional attention in the 110th Congress.

International Taxation

There are some indications that Congress may look to the tax treatment of U.S. firms' foreign income in searching for additional tax revenue. In part, the focus on international taxation stems from a concern about tax benefits that are perceived to promote foreign "outsourcing" — the movement of U.S. jobs overseas.

Economic theory is skeptical about whether tax policy towards U.S. multinationals can have a long-term impact on domestic employment, although short-term and localized impacts are certainly possible. Taxes can, however, alter the extent to which firms engage in overseas operations rather than domestic investment. Under current law, a tax benefit known as "deferral" poses an incentive for U.S. firms to invest overseas in countries with relatively low tax rates. Deferral provides its benefit by permitting U.S. firms to postpone their U.S. tax on foreign income as long as that income is reinvested abroad in foreign subsidiaries. The benefit is generally available for active business operations abroad, but the tax code's Subpart F provisions restrict deferral in the case of income from passive investment. If made, proposals to restrict deferral may consist of expansion of the range of income subject to Subpart F.

In recent years, however, the thrust of legislation has been more in the direction of expanding deferral and cutting taxes for overseas operations. For example, the American Jobs Creation Act of 2004 cut taxes on overseas operations in several ways, while in 2006, TIPRA restricted Subpart F in the case of banking and related businesses receiving "active financing" income and in the case of the "look through" treatment overseas operations receive from subsidiary firms.[10] (See also the discussion of TIPRA, below.) Further, several analysts have recently argued that attempts to tax overseas operations are either counterproductive or outmoded in the modern integrated world economy.[11] Traditional economic analysis, however,

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[10] "Lookthrough" rules generally apply the same treatment of particular items of income in the hands of the recipient as in the hands of a payor. Thus, for example, a dividend paid to a parent out of active business income of a subsidiary would remain active business income in the hands of the parent rather than dividend income (i.e., passive investment income).

[11] Mihir A. Desai and James R. Hines, Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," *National Tax Journal*, vol. 57, Dec. 2004, pp. 937-960. For a critique of Desai and Hines, see Harry Grubert, "Comment on Desai and Hines, "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," *National Tax Journal,* vol. 58, June 2005, pp. 263-278.

suggests that overseas investment that is taxed at a lower or higher rate than domestic income impairs economic efficiency.

Business Tax Legislation, 2001-2006

The **Job Creation and Worker Assistance Act of 2002 (JCWA; P.L. 107-147)** contained temporary "bonus" depreciation provisions that permitted firms to deduct an additional 30% of the cost of property in its first year of service rather than requiring that portion to be depreciated over a period of years. The provision generally applied to machines and equipment (but not structures) and was limited to property placed in service after September 11, 2001, and before January 1, 2005. JCWA also temporarily extended the net operating loss "carryback" period (the years in the past from whose income a firm can deduct losses) to five years from two years. The provision only applied to losses in 2001 and 2002. JCWA also temporarily extended a set of expiring tax benefits (the "extenders" discussed above), many of which applied to business taxes.

While a principal thrust of the **Jobs and Growth Tax Relief Reconciliation Act (JGTRRA; P.L. 108-27)** was accelerating the effective date of individual income tax cuts enacted in 2001, the act also contained a number of business provisions. JGTRRA's tax cuts for dividends and capital gains applied to individual income taxes but nonetheless reduced the tax burden on stockholders' corporate-source income. Under the U.S. classical method of business taxation, corporate source income is taxed twice: once under the corporate income tax and once under the individual income tax — an instance of double-taxation that is thought by economists to inefficiently restrict the flow of capital to the corporate sector. JGTRRA's reductions were an incremental step in the direction of removing the double-taxation — a reform economists term tax "integration." The reductions were temporary, and were scheduled to expire at the end of 2008.

In addition to its capital gains and dividend reduction, JGTRRA increased bonus depreciation to 50% and extended its coverage to the period between May 5, 2003, and January 1, 2005. JGTRRA also temporarily (for 2003, 2004, and 2005) increased the "expensing" allowance for small-business investment from $25,000 to $100,000.

The American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) grew out of legislation designed to end a dispute between the European Union (EU) and the United States over a U.S. tax benefit for exporting (the extraterritorial or ETI provisions) that had been determined to contravene the World Trade Organization agreements' prohibition on export subsidies. The EU objected to the ETI benefit, and imposed countervailing tariffs authorized by the WTO. AJCA repealed ETI, but also enacted a set of new WTO-legal business tax cuts designed, in part, to offset the impact of ETI's repeal on domestic businesses. However, the scope of AJCA substantially transcended ETI and its offsets, and the act was, in its final form, an omnibus business tax bill.

Aside from ETI's repeal, AJCA's most prominent provisions were a new domestic production deduction equal to 9% of income from domestic (but not foreign) production, and a set of tax cuts for multinational firms, including more generous foreign tax credit rules governing interest expense. AJCA also temporarily extended the $100,000 small business expensing allowance (through 2007).

The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA; P.L. 109-222) extended JGTRRA's reduced rates for dividends and capital gains for two years, through 2010. TIPRA also extended JGTRRA's $100,000 small-business expensing-allowance for two years, through 2009.

The Tax Relief and Health Care Act of 2006 (TRHCA; P.L. 109-432) was passed in the post-election session of the 109th Congress. Many of the extenders had expired at the end of 2005, and TRHCA extended them, generally for two years (through 2007).