Business Tax Issues in 2008

(name redacted)
Specialist in Public Finance

June 17, 2008

Congressional Research Service
7-....
www.crs.gov
RL33890

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

In early 2007, congressional action on business taxes began with a focus on small business, to counter the purported adverse impact of an increase in the federal minimum wage on small business. In May, Congress enacted the Small Business Tax Relief Act of 2007 as part of a larger appropriations bill (P.L. 110-28). Among the act's tax measures were an extension of the "expensing" tax benefit for small business investment and an extension of the work opportunity tax credit incentive for hiring members of targeted groups.

As 2007 progressed, Congress considered a number of narrow, sector-specific business tax items. In part, these were provisions designed to promote certain types of economic activity—for example, both the House and Senate considered energy tax provisions aimed at conservation and alternative energy sources. Also, Congress considered extending a set of numerous temporary targeted tax benefits that were scheduled to expire by the end of the year (the "extenders").

Congress also looked to various aspects of business taxation as a means to raise tax revenue that would offset the revenue loss from selected tax cuts it was considering—a key concern given the large and continuing federal budget deficits and House and Senate procedural rules designed to restrain deficit-increasing tax and spending legislation. For example, Congress showed considerable interest in measures to restrict corporate tax shelters, several measures related to international taxation, and a reexamination of the domestic production deduction enacted in 2004.

In the closing months of 2007, Congress began to consider broader revision in corporate taxation. In October, Chairman Charles Rangel of the House Ways and Means Committee introduced H.R. 3970, a business tax bill with a variety of both tax cuts and tax increases. The bill was partly formulated with an eye towards the international economy and the attractiveness of the United States as an investment location. The bill also echoes the classic tax-reform approach of the Tax Reform Act of 1986, proposing to couple its rate cut with a set of base-broadening measures.

In early 2008, Congress focused on stimulating the economy and renewing general farm legislation. In February, Congress enacted the Economic Stimulus Act of 2008. The act's two business investment provisions provided for a temporary increase of small business expensing and temporary "bonus" depreciation limits. In May, the Food, Conservation, and Energy Act of 2008 (P.L. 110-234) was enacted and modified several alternative fuel production tax credits.

Currently, other congressional deliberations regarding business taxation involve energy taxation and the extenders (H.R. 6049, S. 3098, S. 2886, etc.). This report will be updated in the event of significant legislative activity.

Contents

The Current System 2
Legislation in 2007 2
Proposed Tax Reduction and Reform Act (H.R. 3970) 2
Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28) 3
Legislation in 2008 5
Economic Stimulus Act of 2008 (P.L. 110-185) 5
Food, Conservation, and Energy Act of 2008 (P.L. 110-234) 6
Selected Business Tax Issues 6
Research and Experimentation Tax Credit and Other Temporary Benefits 6
Energy Taxation 7
Tax Shelters 8
International Taxation 9

Appendixes

Appendix. Business Tax Legislation and Issues, 2001-2006 11

Contacts

Author Contact Information 13

At the beginning of the 110th Congress, increases in the federal minimum wage were being considered, and both Congress and the Administration evinced support for a cut in small business taxes as a way to partly offset the purported adverse impact of the minimum wage increase on small firms. In May 2007, Congress approved the Small Business Tax Relief Act of 2007 as part of a larger appropriations bill, P.L. 110-28. Among the act's provisions were an extension of the increased "expensing"[1] tax-benefit for small businesses and an extension of the work opportunity tax credit (WOTC) incentive for hiring members of certain targeted groups.

As 2007 progressed, Congress considered a number of narrow, sector-specific business tax items. In part, these were provisions designed to promote certain types of economic activity—for example, both the House and Senate considered energy tax provisions aimed at conservation and alternative energy sources. Also, Congress considered extension of a set of numerous temporary targeted tax benefits that were scheduled to expire by the end of the year (the "extenders").

Congress also looked to various aspects of business taxation as a way to raise tax revenue that would offset the revenue loss from selected tax cuts it was considering. Revenues were a key concern given the large and continuing federal budget deficits as well as House and Senate procedural rules designed to restrain deficit-increasing tax and spending legislation. For example, Congress demonstrated considerable interest in measures to restrict corporate tax shelters, several measures related to international taxation, and a reexamination of the domestic production deduction enacted in 2004.

In the closing months of 2007, Congress began to consider broader revision in corporate taxation. In October, Chairman Charles Rangel of the House Ways and Means Committee introduced H.R. 3970, an omnibus business tax bill with a variety of both tax cuts and tax increases. In part, the bill was formulated with an eye towards the international economy and the attractiveness of the United States as an investment location—it contains, for example, a cut in the general corporate statutory tax rate and a permanent increase in the small business expensing benefit. However, the bill also echoes the classic tax-reform approach of the landmark Tax Reform Act of 1986, proposing to couple its rate cut with a set of base-broadening measures, including a paring-back of the deferral tax benefit for multinational firms and repeal of the domestic production deduction.

In early 2008, Congress focused on stimulating the economy and renewing general farm legislation. In February, Congress enacted the Economic Stimulus Act of 2008, P.L. 110-185. The act's two business investment provisions provided for a temporary increase of small business expensing and temporary "bonus" depreciation limits. In May, the Food, Conservation, and Energy Act of 2008 (P.L. 110-234) was enacted and modified several alternative fuel production tax credits.

Currently, other congressional deliberations regarding business taxation involve energy taxation and the extenders (H.R. 6049, S. 3098, S. 2886, etc.).

[1] "Expensing" describes the timing of certain business deductions permitted by the Internal Revenue Code. Generally, it denotes an item that is permitted to be deducted entirely in the year the firm makes an outlay for the item. When investment outlays are permitted to be expensed rather than deducted gradually—that is, depreciated or amortized—the treatment constitutes a tax-deferral benefit similar to extremely accelerated depreciation. In terms of arithmetic, expensing confers a tax benefit that is the equivalent of a tax exemption for income produced by the expensed investment. See CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by (name redacted), for a more detailed discussion of the expensing provisions.

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.

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 2007, 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.[2]

CBO data show a similar trend regarding corporate tax receipts as a share of total taxes, with an "uptick" in FY2005 and FY2007 from 12.9% to14.4% of total federal revenues. CBO, again, projects the percentage of total revenue from corporate tax revenue to recede to its historical share.[3]

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.

Legislation in 2007

Proposed Tax Reduction and Reform Act (H.R. 3970)

On October 25, 2007, Chairman Charles Rangel of the House Committee on Ways and Means introduced H.R. 3970, the Tax Reduction and Reform Act, an omnibus tax bill containing provisions affecting both individuals and businesses. On the individual side, the bill's principal focuses are reduction of the alternative minimum tax (AMT) and extension of a set of expiring tax benefits. For businesses, the bill couples a substantial cut in the statutory corporate tax rate with a permanent increase in the "expensing" benefit for small business investment with a set of

[2] U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008-2018* (Washington: GPO, 2008), p. 93. Available at the CBO website, at http://www.cbo.gov/publications/bysubject.cfm?cat=0 visited June 16, 2008.

[3] Ibid., p. 150.

revenue-raising provisions. Taken alone, the bill's business provisions would reduce tax revenue by an estimated $8.7 billion over 5 years and $1.0 billion over 10 years.[4]

The bill's proposed reduction in the statutory corporate tax rate is the largest of its proposed cuts, both in terms of revenue loss and number of businesses affected. Under current law, corporate taxable income is generally subject to a set of graduated rates: 15%, 25%, 34%, and 35%, with the lower rates applying to lower increments of income. The bill proposes to replace the top two rates with a single 30.5% rate. Since the bulk of taxable income in the corporate sector is earned by firms subject to the highest rates, most taxable corporate income would benefit from the rate reduction. Taken alone, the rate cut would reduce revenue by an estimated $151.7 billion over five years—over half the estimated revenue loss from all of the proposed corporate tax cuts combined.

A second tax cut in the proposal would make permanent a temporary increase in the "expensing" benefit for equipment investment by relatively small businesses. In addition, the bill proposes to extend for one year a set of other narrowly targeted temporary business tax benefits, most of which expired at the end of 2007. (Note that Chairman Rangel subsequently introduced extensions of these as part of another bill, H.R. 3996. Most recently, the extenders were included in H.R. 6049, which passed the House on May 21, 2008.)

The proposal's revenue-raising items are more numerous than the tax cuts, but smaller in size (though some would reduce revenue by sizeable amounts). Together (and considered apart from the tax cuts), the revenue-raising items would increase business taxes by $164.0 billion over five years. The single largest item is repeal of the 9% deduction for domestic production, which—for income attributable to domestic production—would generally offset 3.15 percentage points of the proposal's 4.5 percentage-point tax-rate reduction. A second sizeable revenue raiser would apply to multinational firms: it would require firms that defer U.S. taxes on foreign-source income to likewise defer deduction of costs attributable to the income. A third sizeable revenue raiser would repeal the Last-In, First-Out (LIFO) method of accounting, and taxing the resulting recognition of income over an eight-year period.

Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)

Congress has had a long-standing interest in tax policy towards small business—an interest that continued in 2007, where action on small business taxation occurred in conjunction with federal minimum wage legislation. The President and others took the position that an increase in the federal minimum wage—an issue acted on early in 2007—should be coupled with consideration of tax cuts for small business. The tax cuts were 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. In mid-March, both the House and Senate folded the tax

[4] U.S. Congress, House Committee on Ways and Means, *Estimated Revenue Effects of Proposals Contained in The Tax Reduction and Reform Act of 2007* (Washington, Oct. 25, 2007). Published in the BNA *TaxCore* service, Oct. 26, 2007.

provisions into their respective versions of H.R. 1591, a supplemental appropriations bill. However, on May 1 President Bush vetoed the bill because of its Iraq-related provisions. On May 24, both the House and Senate approved a modified appropriations bill (H.R. 2206) that included the previous bill's tax provisions (which became known as the Small Business and Work Opportunity Act), the President signed the measure, and it became public law (P.L. 110-28).

The Act's Provisions

As enacted, the Small Business and Work Opportunity Tax Act provided for tax cuts amounting to an estimated $7.1 billion over 5 years and $4.8 billion over 10 years. The cuts were partly offset by revenue-raising items amounting to $7.0 billion over 5 years and $4.4 billion over 10 years, for a net revenue gain of $71 million over 5 years and $55 million over 10 years—a net effect near to revenue neutrality.[5] Taken alone, the revenue-losing and revenue-gaining measures in the conference agreement fell between the House and Senate bills, in terms of their size. The Senate version of the bill provided both for larger tax cuts and revenue offsets than did the House bill.

The act's final tax cuts were generally, though not exclusively, targeted at small business. A prominent provision was an extension of the *"expensing" tax benefit for business investment* in machines and equipment—a tax benefit provided by Section 179 of the tax code. The provision is linked to small business because it applies only to firms undertaking less than a certain level of investment. The provision is a tax benefit in that it permits firms to deduct ("expense") 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 with most tangible assets. 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.[6] 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 amounts for 2007 were $112,000 and $450,000. The most recent extension was provided by TIPRA in 2006 and extended the increased allowance and threshold through 2009. P.L. 110-28 extended the increased expensing allowance through 2011 and also increased the allowance to $125,000 and the phase-out threshold to $500,000.

Another temporary tax benefit the act addressed was the *work opportunity tax credit (WOTC)*. In general, WOTC permits employers to claim a tax credit equal to a specified percentage paid in first-year wages to members of certain targeted groups, including families receiving Temporary Assistance for Needy Families (TANF) support, qualified veterans, high-risk youth, and others. Under prior law, WOTC was scheduled to expire at the end of 2007; P.L. 110-28 extended the credit through August 2011 and made several modifications in qualification criteria for the targeted groups.[7]

---

[5] Revenue estimates are by the Joint Committee on Taxation, and are taken from U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of Revenue Provisions Contained in the Conference Agreement for H.R. 1591*, JCX-25-07, Apr. 24, 2007.

[6] 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.

[7] See CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by (name redacted), for a description of the WOTC.

The act modified the *tax credit employers can claim against social security (FICA) taxes paid for employees who receive tips*. The modification was designed to keep the new, higher minimum wage from having the effect of reducing the credit. Under both the act and prior law, the credit is equal to the employer's FICA tax on tips in excess of those meeting the minimum wage requirement. Absent other changes, an increase in the minimum wage reduces the tax credit, by increasing the threshold over which the tax credit is earned.

P.L. 110-28 increased the minimum wage to $7.25 from prior law's $5.15 and would have reduced the tax credit, absent other changes. However, the act provided that the credit will continue to be calculated based on prior law's minimum wage. The act also provided that both the FICA credit and WOTC can offset a taxpayer's alternative minimum tax.

The act contained two principal revenue-raising provisions. One increased the scope of the *"kiddie tax"*—a provision that taxes children under the age of 18 at their parents' tax rate on unearned income exceeding a certain threshold. The act increased the applicable age by one year (i.e., under age 19), or under 24, if full-time students. The second revenue-raising provision lengthened the *period after which interest and penalties are suspended* for unpaid taxes, in cases where the taxpayer has not received a notice from the IRS.

Legislation in 2008

Economic Stimulus Act of 2008 (P.L. 110-185)

Recent economic indicators suggest that economic growth is slowing and the economy may be headed for—or already in—a recession. In response to weaker economic growth, the Recovery Rebates and Economic Stimulus for the American People Act of 2008 (H.R. 5140) was introduced by Speaker Pelosi and passed by the House of Representatives on January 29. On January 30, the Senate Committee on Finance reported the Economic Stimulus Act of 2008, which contained provisions not included in the House bill. On February 7 the Senate adopted the House bill with added rebates for retirees and the House adopted the revised bill. On February 13 the bill was signed into law as P.L. 110-185.

The Act's Provisions

As enacted, the Economic Stimulus Act of 2008 provided for tax cuts amounting to an estimated $134 billion over 5 years and $124.5 billion over 10 years.[8] The cuts were not offset by revenue-raising items. Among the tax cuts were two which affect business investment. These business tax cuts were estimated to reduce federal revenue collections by an estimated $17 billion over 5 years and $7.5 billion over 10 years.

The first business investment provision allows a temporary, one year increase in the limitations on the expensing of certain depreciable business assets. As described above, expensing is a tax benefit, provided by Section 179 of the tax code, which permits certain small firms to deduct

[8] Revenue estimates are by the Joint Committee on Taxation, and are taken from U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects Of The "Economic Stimulus Act Of 2008," As Passed By The House Of Representatives And The Senate On February 7, 2008*, JCX-17-08, Feb. 8, 2008.

certain investments in the first year of service rather than gradually depreciating the asset over time. The provision increased the amount of investment eligible for expensing from $128,000 to $250,000 in 2008, and the start of the phase-out range from $510,000 to $800,000.

The second business investment provision allows for temporary "bonus" depreciation, for certain property acquired in 2008, that permit firms to deduct an additional 50% of the cost of property in the first year of service rather than gradually depreciating the whole value of the asset over time.

Food, Conservation, and Energy Act of 2008 (P.L. 110-234)

The Act's Provisions

As enacted, the Food, Conservation, and Energy Act of 2008 renewed multiple agriculture-related programs, at a cost of $289 billion over 5 years and $605 billion over 10 years. Among the tax-provisions which affect businesses were several tax credits for the production of fuels from alternative sources.[9] These provisions are estimated to increase federal revenue collections by $1 billion over 10 years.

Selected Business Tax 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: 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 overall 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 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,

[9] See CRS Report RL34696, *The 2008 Farm Bill: Major Provisions and Legislative Action*, by (name redacted) et al., for a more complete description of the Act's energy-related provisions.

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.)[10]

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 expired at the end of 2007; the 2006 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 periodic action if they are not to expire, and in part because of the strong support for many of the benefits.[11] As noted above, an element of the Tax Reduction and Reform Act (H.R. 3970) that was introduced in October 2007 proposes a one-year extension of a number of expiring tax provisions, including the R&E tax credit. On October 30, Chairman Charles Rangel of the House Ways and Means introduced a bill (H.R. 3996; the Temporary Tax Relief Act) devoted only to extending expiring provisions and providing a "patch" that would reduce the individual alternative minimum tax for one year. The alternative minimum tax bill that Congress enacted in December, however, did not contain tax provisions other than those pertaining to the alternative minimum tax.

The extenders have continued to receive congressional attention in 2008. H.R. 6049, the Energy and Tax Extenders Act of 2008, which was passed in the House on May 21, 2008, provides a one-year extension through 2008 for many of the expiring temporary tax provisions, while S. 2886, the Alternative Minimum Tax and Extenders Tax Relief Act of 2008, proposes a two-year extension through 2009 for the majority of the temporary tax provisions contained in the bill.

Energy Taxation

At the outset of 2007, Democratic leaders stated that energy taxation was an issue they intended to address during the year. Their focus appeared to be two-fold: a revenue-raising, scaling-back of tax cuts that were enacted in recent years for the petroleum firms and enactment of a new set of incentives aimed at energy conservation and promotion of alternative energy sources. Those goals were addressed, in part, in an energy bill (H.R. 6) the House passed in January 2007. The bill contained both tax and non-tax provisions. Its tax measures restricted several tax benefits as they apply to oil and gas production, and provided that the resulting tax revenues were to be used to fund a reserve for energy efficiency and renewable energy.

In June, the Senate began consideration of its own, amended, version of H.R. 6, which included a wide-ranging, non-tax ("policy") component. While the Senate Finance Committee approved a tax package of revenue-raising items and provisions to promote conservation and alternative energy sources, the tax plan was not added to the policy component of H.R. 6 because of

---

[10] See CRS Report RL31181, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress*, by (name redacted), for a more complete description of the R&E credit.

[11] For a list of extenders addressed by TRHCA, see CRS Report RL33768, *Major Tax Issues in the 110th Congress*, by (name redacted), and for a broader discussion on extenders, see CRS Report RL32367, *Certain Temporary Tax Provisions ("Extenders") Expired in 2007*, by (name redacted) and (name redacted).

opposition to its revenue-raising provisions—especially a tax on oil and gas from the Gulf of Mexico and restrictions on leasing transactions involving foreign property.[12]

The House Ways and Means Committee approved a bill (H.R. 2776), on June 20, that—unlike H.R. 6—was restricted to energy tax provisions. Like the Finance Committee measure, it contains a mix of revenue raisers and tax benefits. The bill was approved by the House on August 4, 2007.

In broad outline, the Finance Committee legislation and House bills are similar in certain respects, with their conservation and alternative fuels measures partly offset by revenue-raising items. They differ, however, in the exact make-up of the respective components and in the magnitude of their revenue effects. Specifically, the Finance Committee bill contains revenue-losing items estimated to reduce revenue by a total of $32 billion over 10 years, and revenue-raisers expected to increase revenues by the same amount, thus achieving approximate revenue neutrality on a net basis. The House bill is likewise estimated to achieve revenue neutrality, but the expected magnitude of its respective revenue raisers and revenue-losing provisions is smaller, totaling $15 billion over 10 years in each case.

Prominent among the tax benefits in both bills is extension and modification of the tax credit for production of energy from renewable sources provided by Section 45 of the tax code, although the Finance Committee's version would result in a larger revenue loss. The remaining revenue-losing items in the two bills differ considerably.

A large revenue-raising item common to both bills is the denial of the tax code's Section 199 domestic production deduction to certain oil- and gas-related income.[13] The deduction was first enacted with the American Jobs Creation Act of 2004 (P.L. 108-357) and it 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. The House bill would deny the deduction to all domestic production of oil and gas; the Finance Committee measure would deny the deduction to integrated oil companies.

In December, the Senate failed to take action on an energy bill containing the tax provisions advocated by the Finance Committee, and Congress instead approved comprehensive energy legislation stripped of most of its tax elements (The Energy Independence and Security Act of 2007, P.L. 110-140).

Tax Shelters

Corporate "tax shelters" are another area where Congress may look for tax increasing revenues. They 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

[12] Heather M. Rothman, "Senate Energy Tax Package Could Be Doomed in House," BNA *Daily Tax Report*, June 26, 2007, p. G-1.

[13] 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.

return or increased risk for the participant.[14] 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.[15] In 2006, the Senate version of the Tax Increase Prevention and Reconciliation Act (TIPRA, P.L. 109-222) 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 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.

Several bills in the 110th Congress have included codification of the economic substance doctrine as a revenue-raising "offset" for tax cuts elsewhere in the tax code. These include S. 2242, approved by the Senate Finance Committee on October 25, 2007, and H.R. 3970, proposed by Chairman Charles Rangel of the House Ways and Means Committee, also on October 25.

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.

---

[14] 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.

[15] For a list and description, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals Considered in the 108th Congress*, by (name redacted).

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.[16] Further, several analysts have recently argued that attempts to tax overseas operations are either counterproductive or outmoded in the modern integrated world economy.[17] Traditional economic analysis, however, suggests that overseas investment that is taxed at a lower or higher rate than domestic income impairs economic efficiency.

[16] "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 firm 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).

[17] 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.

Appendix. Business Tax Legislation and Issues, 2001-2006

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. JGTRRA, however, contained a number of tax cuts aimed at businesses, as did legislation enacted in 2002, 2004, and 2006.

The most prominent business tax cuts can be summarized as follows: temporary "bonus" depreciation provisions 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—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?
- 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 do the deduction and other competitiveness provisions interfere with the efficient and flexible participation of U.S. businesses in the world economy?

Enacted Legislation

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 originally 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. (In early 2007, P.L. 110-28 extended the increased expensing allowance through 2010.)

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).

Author Contact Information

(name redacted)
Specialist in Public Finance
/redacted/@crs.loc.gov, 7-....