Business Tax Issues in 2010

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Summary

In 2009, congressional debate focused primarily on stimulating the economy, health care reform, and climate change. These issues are not only interrelated, but are also intimately linked with the taxation of businesses. For example, in February, Congress enacted the American Recovery and Reinvestment Act of 2009 (P.L. 111-5). Two of the act's business tax provisions provided for a temporary increase of small business expensing and temporary "bonus" depreciation limits, while other provisions allow a delayed recognition of cancelation of debt income and five-year carryback of net operating losses for small businesses. The act also modified several renewable energy provisions, including the Renewable Energy Production Tax Credit, the Investment Tax Credit, and tax credit for Alternative Fueling Property.

Congressional debate in 2010 has focused on extending selected expired tax provisions and reforming health care. In particular, the Tax Extenders Act of 2009, H.R. 4213, passed the House on December 9, 2009, and the Senate on March 10, 2010. In addition, the debate on health care reform is ongoing and the President's Fiscal Year 2011 Budget Proposal calls for the modification of selected business taxes, the removal or restriction of several oil and gas tax provisions, and reforming international taxation.

As the year progresses, it is anticipated that congressional deliberations will consider the extension of several expiring business tax provisions, energy taxation, tax shelters, and international taxation, while continuing to examine opportunities for economic stimulus.

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As the year progresses, it is anticipated that congressional deliberations will consider the extension of several expiring business tax provisions, energy taxation, tax shelters, and international taxation, while continuing to examine opportunities for economic stimulus.

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 FY2005 and FY2007—rising to 2.3% and 2.7% of GDP, respectively—before reverting to a historically normal 2.1% in 2008 and falling to 1.0% in 2009. CBO projects corporate tax revenue as a percentage of GDP to remain at this level through 2010, reflecting reduced corporate profits due to the economic recession, before trending upward beginning in 2011.[1]

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% to 14.4% of total federal revenues, before reverting to a 12.1% in 2008 and then dramatically falling to 6.6% in 2009. CBO, again, projects the percentage of total revenue from corporate tax revenue to remain depressed through 2010.

[1] U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010-2020*, (Washington: GPO, 2010).

Not all businesses are subject to the corporate income tax, however. 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.[2] Also, businesses that have no more than 100 stockholders and 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.

Selected Business Tax Policy Questions

As Congress debates business tax policy, several policy questions are commonly raised. These questions highlight three criteria that tax policy experts find informative for the evaluation of tax policy options. In general terms the criteria are equity, economic efficiency, and administrability.[3] The policy questions are 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 is the effect of the business tax cuts on the overall fairness of the tax system? Do the reductions accrue primarily to relatively high-income stockholders and corporate creditors, or will any reductions on tax progressivity be outweighed by positive employment effects?
- How will 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?

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[2] A partnership is a joint venture consisting of at least two partners organized to operate a trade or business with each partner sharing profits, losses, deductions, and credits. For more information on business organization forms see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by (name re dacted).

[3] In general terms, equity refers to the subjective fairness of the tax system; economic efficiency is concerned about the allocation of resources within the economy; and administrability relates to the costs of administering the tax system. In all feasible tax systems, trade-offs between these three criteria are required.

Legislation in 2010

The President's Fiscal Year 2011 Budget Proposal

The President's Fiscal Year 2011 Budget Proposal proposes to modify selected business taxes, remove or restrict several coal, oil, and gas tax provisions, and reform international taxation. Taken as a whole, the Joint Committee on Taxation estimated that these provisions would increase the overall level of business taxation relative to current law.

General Business Tax Provisions

The President's budget contains proposals to raise selected general business taxes, while lowering other general business taxes. On net, the budget proposes to increase the level of business taxation.

The most prominent of these business tax proposals, in terms of revenue, is the repeal of last-in first-out (LIFO) inventory accounting (estimated to raise $75.3 billion over 10 years).[4] Under LIFO, a firm records the last units purchased as the first units sold. Given that prices generally rise over time because of inflation, this method records the sale of the most expensive inventory first and thereby decreases profit and reduces taxes. In addition, the President's budget proposes to codify the "economic substance doctrine" ($7.2 billion), tax carried interest as ordinary income ($28.6 billion), and reinstate a series of superfund taxes ($19.2 billion).[5]

Additionally, the President's budget contains several provisions that would general business tax receipts. The most prominent of these proposals, in terms of revenue, is to make the Research and Experimentation tax credit permanent ($70.5 billion).[6] The budget also proposes to eliminate capital gains taxation on small businesses ($7.9 billion).

[4] All revenue estimates of the President's Fiscal Year 2011 Budget Proposal are for the Fiscal Year 2010-2020 budget window and are from U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget*, committee print, 111th Cong., 2nd sess., March 8, 2010, JCX-7-10 (Washington: GPO, 2010).

[5] Carried interest is a form of income earned by general partners based on the performance of the partnership. The Tax Extenders Act of 2009 (H.R. 4213) also proposes taxing carried interest as ordinary income. For more information on carried interest see CRS Report RS22689, *Taxation of Hedge Fund and Private Equity Managers*, by (name redacted) and (name redacted) and CRS Report RS22717, *Taxation of Private Equity and Hedge Fund Partnerships: Characterization of Carried Interest*, by (name redacted). The economic substance doctrine refers to a judicially developed "rule" that may deny tax benefits to transactions that technically comply with the Internal Revenue Code but have no underlying economic value. For more information on the economic substance doctrine see CRS Report RS22846, *The Economic Substance Doctrine: Legal Analysis of Proposed Legislation*, by (name redacted). Superfund taxes refer to dedicated taxes on petroleum, chemical feedstocks, and corporate income that were used to fund environmental remediation projects. For more information on superfund taxes see CRS Report RL31410, *Superfund Taxes or General Revenues: Future Funding Issues for the Superfund Program*, by (name redacted), (name redacted), and (name redacted).

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

Coal, Oil, and Gas Provisions

The President's budget proposes to repeal or modify a number of coal, oil, and gas provisions.[7] Among the provisions proposed for repeal are the Section 199 production activities deduction, percentage depletion, and expensing of intangible drilling costs.[8] Taken together, these provisions in the President's Budget Proposal are estimated to raise approximately $40 billion over the 2010-2020 budget window. Additionally, general provisions, such as the repeal of LIFO, modification of the tax rules for dual-capacity taxpayers and the reinstatement of the superfund taxes, are expected to also impact the coal, oil, and gas industries.

International Provisions

The President's budget proposes changes to rules on deferral, foreign tax credits, and transfer pricing.[9] The deferral proposal would eliminate a U.S. person's ability to currently deduct interest expenses that are related to deferred foreign-source income; instead the deduction for those expenses would be deferred until the foreign-source income is subject to U.S. tax. The remainder of the deductions could be carried forward ($35.5 billion). The foreign tax credit proposals would prorate foreign taxes over the taxpayer's entire foreign income, including deferred income and address issues inappropriate separation of creditable foreign taxes from the associated foreign income ($53.7 billion). In effect this would negate the ability of taxpayers to cherry-pick repatriations from high-tax countries—and reinvest low-tax country profits offshore—to maximize the foreign tax credit. Finally the proposals related to transfer pricing are intended to tax any excessive returns generated by the transfer of intangible assets to affiliates in low-tax countries ($12.4 billion).

Health Care Reform

One aspect of the congressional debate over health care reform is the effect on small business.[10] Specifically, there is concern over the effect of a "pay or play" mandate to require firms to provide health insurance for their employees or pay a penalty. Current proposals have exemptions for small businesses, and also propose to provide subsidies for purchasing insurance. Economic theory suggests that health insurance costs (and any penalties) will be passed on to labor income, but that may be more difficult for employers of lower-wage workers. Furthermore, average wages are generally lower for small firms (except for the smallest).

Both the House bill (H.R. 3962, passed on November 14, 2009) and the Senate bill (H.R. 3590) would exempt small businesses from penalties. The House bill would apply no penalties to firms

[7] See CRS Report R40999, *Energy Tax Policy: Issues in the 111th Congress*, by (name redacted) and (name red acted) for information on the current status of U.S. energy tax policy.

[8] Percentage depletion, and the expensing of intangible drilling costs currently reduce the taxable income of the coal, oil and gas industries through accelerated capital cost recovery (relative to economic depreciation). The Section 199 production activities deduction reduces taxable income by a fixed percentage of income from domestic (but not foreign) production.

[9] See CRS Report RL32749, *U.S. Taxation of Overseas Investment and Income: Background and Issues*, by (name reda cted) for background on the U.S. taxation of overseas investment and income.

[10] See CRS Report R40775, *Health Care Reform and Small Business*, by (name redacted) for a complete discussion of issues related to health care reform and small businesses.

with $500,000 or less in payroll, and the Senate bill would exempt firms with 50 or fewer employees. As a result, very few smaller businesses would be affected.

The proposals also provide temporary credits to subsidize small employers' contributions to health insurance for lower-income employees. The size of the subsidies depends on the size of the firm and the firm's average employee compensation. The credits are the same in the two bills (except that the Senate bill allows a smaller credit for nonprofits), and would be as much as 50% of the employer's cost. The subsidy for taxable firms is provided as a nonrefundable income tax credit and would not benefit firms with no income tax liability; the Senate bill has a separate 35% credit against payroll taxes for nonprofits.

The Tax Extenders Act of 2009 (H.R. 4213)

The Tax Extenders Act of 2009 is expected to provide businesses with tax relief through the one year extension of multiple tax provisions that expired at the end of 2009. The House- and Senate-passed versions of H.R. 4213 differ primarily in the revenue offsets utilized. Both versions propose to extend the research credit ($6.6 billion); the active financing exception from Subpart F of the tax code ($3.9 billion); the special 15-year cost recovery period for certain leasehold, restaurant, and retail improvements ($4.9 billion); and incentives for biodiesel and renewable diesel ($1.0 billion).[11] The House-passed version of H.R. 4213 offsets the cost of extending multiple tax provisions though the taxation of carried interest as ordinary income and an accounting change in the payment of corporate estimated taxes. In contrast, the Senate-passed version of H.R. 4213 proposes to offset the cost of extending multiple tax provision primarily through a codification of the "economic substance doctrine" and an exclusion of tax benefits for "black liquor."[12]

A proposed amendment to H.R. 4213, the American Jobs and Closing Tax Loopholes Act of 2010, would continue to extend these provisions, but would offset the cost with multiple measures including treating a portion of carried interest as ordinary income and closing several international tax loopholes.[13] Several of the international tax provisions were also included in the President's Budget Proposal and are intended to curtail abuses of the U.S. foreign tax credit system and other targeted areas. These international provisions are estimated to raise $14.5 billion over 10 years.

[11] All revenue estimates are for the Fiscal Year 2010-2020 budget window and are from U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects Of The Revenue Provisions Contained In The "American Workers, State And Business Relief Act Of 2010," As Passed By The Senate On March 10, 2010* , committee print, 111th Cong., 2nd sess., March 10, 2010, JCX-9-10.

[12] The term "black liquor" currently refers to a process in which pulp mills use a mixture of conventional fuel and a byproduct of the pulping process as an energy source for the mill. According to changes enacted in The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (P.L. 109-59; SAFETEA-LU), "black liquor" is currently eligible for the alternative fuels tax credit, which was not the congressional intent of the provision. See CRS Report R40999, *Energy Tax Policy: Issues in the 111th Congress*, by (name redacted) and (name red acted) for more information on "black liquor."

[13] A summary of the amendment is available at http://waysandmeans.house.gov/media/pdf/111/ America_Jobs_Summary.pdf.

Legislation Enacted in 2009

American Recovery and Reinvestment Act of 2009 (P.L. 111-5)

The American Recovery and Reinvestment Act of 2009 (ARRA) contained multiple business tax provisions. The majority of these provisions can be grouped into two general categories of incentives: those which promote investment in alternative energy and those which benefit the cash-flow of businesses.

The major business-related energy incentives in ARRA focused on promoting renewable energy.[14] The principal renewable energy provision increased the number of facilities eligible for the Renewable Energy Production Tax Credit (PTC) through a three-year extension of the placed-in-service date requirement. This provision was estimated to cost $13.1 billion over the next 10 years and composed approximately 73% of the cost of the business-related energy provisions in ARRA.[15] The remainder of the energy provisions focused on modifications to the Investment Tax Credit (ITC), including the creation of the Advanced Energy Manufacturing Facility Investment Tax Credit, which were estimated to cost $2.3 billion over 10 years.

The major business incentives in ARRA focus on increasing near-term cash flow. Specifically, the acceleration of capital cost recovery and deferral of certain income related to the discharge of indebtedness reduce taxable business income and, thus, business tax receipts. ARRA contained two provisions that accelerated capital cost recovery: an extension of bonus depreciation and enhanced small business expensing. The deferral of certain income related to the discharge-of-indebtedness provision allowed for the deferral of cancellation of debt income (CODI) for four or five years and recognized the CODI as income over the following four years. These three provisions were estimated to cost approximately $6.7 billion over 10 years. In contrast, the remaining business incentives in ARRA were estimated to raise nearly $600 million over 10 years.

The Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-92)

The Worker, Homeownership, and Business Assistance Act of 2009 contained several business tax provisions. The business tax provisions included an extension of the carryback period for business losses (NOL) and a delay in the implementation of the worldwide interest allocation rules.

The act extended the carryback period to five years for all business taxpayers except those who received certain federal assistance relating to the financial crisis.[16] A taxpayer could use the

[14] See CRS Report R40412, *Energy Provisions in the American Recovery and Reinvestment Act of 2009 (P.L. 111-5)*, coordinated by (name redacted), for a complete description of the energy provisions in ARRA.

[15] The revenue estimates used in the section are all contained in U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in The Conference Agreement For H.R. 1, The "American Recovery And Reinvestment Tax Act of 2009",* committee print, 111th Cong., 1st sess., February 12, 2009, JCX-19-09.

[16] See CRS Report RL34535, *Net Operating Losses: Proposed Extension of Carryback Period*, by (name redacted) (continued...)

extended carryback period for an NOL incurred in 2008 or 2009, but not both. The amount of loss that could be carried back to the fifth year was limited to 50% of the taxpayer's taxable income in the fifth carryback year. This limitation, however, did not apply to businesses with $5 million or less in gross receipts that made a five-year carryback election after enactment of the bill. This provision was estimated to cost $10.4 billion for FY2010 through FY2019.

The act also delayed the implementation of the worldwide interest allocation rule until 2018.[17] The worldwide interest allocation provision was designed to correct what some argue was an imperfection in the design of the foreign tax credit rules. In general, the tax code places a limit on the foreign tax credit. To calculate the limit, firms are required to separate interest and other expenses according to source—foreign or domestic. Some believed that implementing worldwide interest allocation would shield taxpayers from double taxation of foreign-source income. This provision was estimated to raise $20.1 billion for FY2010 through FY2019.

Selected Business Tax Issues

Business Tax Cuts to Stimulate the Economy

After the passage of ARRA, the 111th Congress has continued deliberations focused on stimulating the economy. One topic of these discussions was on how the tax code—and business provisions—could aid economic conditions. Given the policy goal of increasing aggregate demand, business tax cuts, such as in ARRA, have traditionally focused on "cash-flow" and investment measures.

Cash-flow provisions attempt to stimulate the economy by allowing businesses to increase their cash on hand by realizing existing tax attributes in the current period, as opposed to future years. These measures allow businesses immediate access to working capital that may be useful to maintaining business operations. An example of a cash-flow measure in ARRA was the extension of the net operating loss carryback period from two to five years. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) enacted a similar provision for qualified losses occurring in the Gulf Opportunity Zone (or GO Zone).

Investment measures attempt to stimulate the economy by inducing investment spending, typically through measures that change the cost of capital. Examples of investment measures in ARRA were one year extensions—through the end of 2009—of bonus depreciation and small business expensing.[18] The Economic Stimulus Act of 2008 (P.L. 110-185) also contained a one-year extension of these provisions, covering 2008.

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for a complete discussion of issues pertaining to net operating losses.

[17] See CRS Report RL34494, *The Foreign Tax Credit's Interest Allocation Rules*, by (name redacted) and (name reda cted) for a complete discussion of issues related to interest allocation rules.

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

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—each were enacted for only fixed periods of time, and are 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. 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. 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. 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.

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 firms' increases 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 is, 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.)[19]

The R&E credit's most recent extension was provided by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) in October 2008. The act also increased the rate for the alternative simplified credit (ASIC) from 12% to 14% and repealed the alternative incremental research credit (AIRC) for the 2009 tax year only. In the 111th Congress, there has been interest in extending the R&E credit and 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.[20] As noted above, an element of Division C of P.L. 110-343, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, extended the R&E credit. In addition, the act retroactively extended several temporary tax provisions for individuals and businesses through December 31, 2009.

Tax extenders have continued to receive congressional attention in 2010, through passage of the Tax Extenders Act of 2009 (H.R. 4213), which is discussed above, by both the House and Senate.

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[19] 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.

[20] For a list of extenders addressed by Tax Relief and Health Care Act of 2006, 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 Scheduled to Expire in 2009 ("Extenders")*, by (name redacted) and (name red acted).

Energy Taxation

At the outset of the second session of the 111th Congress, the focus of energy taxation appears to be two-fold: enactment of a new set of incentives aimed at energy conservation and promotion of alternative energy sources and a revenue-raising, scaling-back of tax cuts that were enacted in recent years for the oil and gas companies.

The first of these two goals were addressed, in part, in ARRA, which contained a number of provisions to encourage investment in alternative energy and alternative energy production. These provisions are outlined above.[21]

In addition, the President's FY2011 Budget Outline contains several provisions aimed at achieving the second goal.[22] If fully enacted the provisions would eliminate tax preferences for the oil and gas industry estimated to raise $36.5 billion over 10 years. The repeal of the Section 199 domestic production deduction, enacted in The American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) and never fully implemented, accounts for over 40% of this total. Another nearly 44% of the total is achieved through the elimination of two provisions enacted during World War I: the expensing of intangible drilling costs and percentage depletion, discussed above.

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.[23] 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.[24] But the term is so vague and general in most usages that it is sometimes 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 (constitute "tax evasion") or legal (constituting "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.[25] In 2006, the Senate

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[21] See CRS Report R40999, *Energy Tax Policy: Issues in the 111th Congress*, by (name redacted) and (name red acted) for a complete discussion of the energy tax provisions contained in ARRA.

[22] Office of Management and Budget, *Budget of the Federal Government: Fiscal Year 2011*, Washington, D.C., February 1, 2010, Table S-8.

[23] See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by (name redacted) for additional inforamtion on corporate tax shelters.

[24] 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, September 1985, pp. 305, 307.

[25] 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).

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 report.

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.

The President's FY2011 Budget Outline includes the codification of the economic substance doctrine as a revenue-raising "offset" for tax cuts elsewhere in the tax code. This provision is estimated to raise $4.2 billion over 10 years.

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.[26] 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 AJCA 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.[27] Further, several analysts have argued that attempts to tax overseas operations are either counterproductive or outmoded in the modern integrated world economy.[28] Traditional economic analysis, however, suggests that

[26] See CRS Report RL32749, *U.S. Taxation of Overseas Investment and Income: Background and Issues*, by (name reda cted).and CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by (name redacted) for additional information how U.S. tax policy and its affect on multinational corporations.

[27] "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).

[28] 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, December 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* (continued...)

overseas investment that is taxed at a lower or higher rate than domestic income impairs economic efficiency.[29] However, a consensus appears to be emerging that the U.S. corporate income tax rate should be reduced.[30]

(...continued)

Journal, vol. 58, June 2005, pp. 263-278.

[29] See CRS Report RL32749, *U.S. Taxation of Overseas Investment and Income: Background and Issues*, by (name reda cted).

[30] "Rangel Finds Near-Unanimous Support for Corporate Rate Cuts at Summit," *Tax Notes Today*, February 23, 2009.

Appendix. Business Tax Legislation and Issues, 2001-2008

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 nearly each year since 2004.

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).

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).

The Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28) continued Congress's long-standing interest in tax policy towards small business. Tax cuts for small business (increased business expensing and the work-opportunity tax credit) were included as a means of offsetting the extra cost burden the higher minimum wage.

The Economic Stimulus Act of 2008 (P.L. 110-185) contained two provisions which affect business investment; a temporary, one year increase in the limitations on the expensing of certain depreciable business assets and temporary "bonus" depreciation, for certain property acquired in 2008. Both provisions permit firms to deduct a greater percentage of the cost of property in the first year of service rather than gradually depreciating the whole value of the asset over time.

The Food, Conservation, and Energy Act of 2008 (P.L. 110-234) included tax-provisions which affect businesses were several tax credits for the production of fuels from alternative sources.[31]

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended a number of business tax provisions and created or modified a number of renewable energy and energy efficiency provisions.

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

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