Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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WITH FULLY OFFSET TAX EXTENDER BILL, HOUSE ADVANCES IMPORTANT FISCAL PRINCIPLE; SENATE SHOULD FOLLOW

By Chuck Marr

The House tax extender bill represents a step forward in the important effort to reinstate a pay-as-you-go norm to federal legislation — a norm that played a key role in enabling the White House and Congress to turn large deficits into substantial surpluses in the 1990s

The nation is on an unsustainable fiscal path, and policymakers will soon face wrenching decisions on both spending and taxes. Over the immediate term, Congress has properly pursued an expansionary fiscal policy and needs to do more to address the weak labor market. Simultaneously, it needs to begin changing the nation's long-term fiscal direction. The consensus in Washington that Congress should fully pay for health reform and also put downward pressure on the long-term growth in health care costs is a critical first step. Congress must return to a policy norm under which entitlement or tax legislation that costs money is financed with corresponding spending cuts or tax increases.

The House extenders bill fulfills the pay-as-you-go requirement without any near-term spending cuts or tax increases that would undercut efforts to bolster the economy over the next two years. For one thing, the bulk of the increase in revenues to offset the cost of the extenders will occur after 2011, so the bill does not increase net taxes this year and next when the economy will remain especially fragile. For another, the specific tax increases proposed as offsets are the kinds of tax increases — eliminating an unfair tax preference for high-income individuals and cracking down on tax evasion — that economists agree will not hinder economic growth.

The House bill extends a $31 billion package of largely corporate tax provisions, as well as some individual ones. It will not add to the nation's total borrowing over the next ten years, however, because the bill also includes two very sound provisions that would fully offset the cost over that period. First, a "carried interest" provision, which would raise an estimated $25 billion over ten years, would close a loophole that allows some financial services managers to treat certain compensation as a capital gain. Second, the bill cracks down on tax evasion through the use of certain foreign bank accounts, which would raise about $8 billion over ten years.

The Senate should seriously consider these specific offsets. Whether or not it includes them, the Senate should follow the House's lead and fully pay for its tax extender package in a manner that does not undermine the economic recovery. And the Administration should insist on a fiscally disciplined approach.

Need to Return to "Pay-as-You-Go" as the Norm

Two decades ago, as part of a 1990 bipartisan budget agreement, Congress adopted a "pay-as-you-go" fiscal policy rule that was a great success,[1] helping to instill fiscal discipline as a policy reflex. "How will you pay for it?" arguably became a defining fiscal phrase of that period. When large deficits turned to large surpluses, however, Congress abandoned this rule as well as fiscal discipline. After a decade of massive tax cuts, wars in Iraq and Afghanistan, a new prescription drug benefit for seniors — all on an unpaid basis — and a deep recession, the nation's fiscal situation has deteriorated markedly. Once the economy sufficiently recovers, policymakers will face wrenching decisions on what spending to cut and what taxes to raise to address the nation's unsustainable fiscal path.

While policymakers will need to take aggressive affirmative steps, it is also important that they re-establish the fiscal "do no harm" norm. The consensus on the need to pay for health reform legislation is a significant step. A smaller, but still important, step is the House's decision to pay for the new tax extender bill. It is important because "tax extender" legislation comes before Congress perennially and the House's action demonstrates an effort to make "pay-as-you-go" routine once again for any legislation not responding to real emergencies or providing an essential, temporary boost to the economy.

The Tax Extender Package

The House bill is a one-year extension of a hodge-podge of about 50 tax provisions that are scheduled to expire at year-end. The largest ones include a general research and development (R&D) tax credit as well as many industry-specific provisions. For example, the so-called Subpart F provision allows the financial services sector to defer corporate taxation indefinitely on some money it earns outside of the United States. The bill also includes special expensing or depreciation rules for select industries such as farm equipment, restaurants, and movie and television production. In total, the package would cost $31 billion over ten years, according to the Joint Tax Committee.

The constant one-year nature of tax extender legislation creates uncertainty and makes it difficult for affected taxpayers to plan. This is particularly true for the R&D tax credit, in which the incentive to invest can be undermined by the annual uncertainty. This temporary nature, however, does have an advantage and presents a future opportunity for Congress. It can take a close look at the provisions, particularly with the given fiscal outlook in mind. The eventual expiration of some provisions would be a small step to at least slightly streamline the tax code. Alternatively, if Congress decides that the provisions are meritorious, policymakers should enact longer extensions and fully pay for them.

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[1] See James Horney and Richard Kogan, "Reinstatement of Pay-As-You-Go Is a Welcome Step Toward Fiscal Responsibility," December 20, 2006. http://www.cbpp.org/files/12-20-06bud.pdf.

Carried Interest

A common arrangement between private equity fund managers and their investors is for the managers to receive a small management fee (e.g., one percent of assets) plus 20 percent of fund profits (perhaps with a threshold hurdle rate — a rate of profit that the fund has to achieve before the managers start to receive their share of fund profits). The managers assume the role of "general partners" in the structure and the law treats their share of profits — their "carried interest" — as capital gains. This money should be taxed as ordinary income, as the House has proposed, for two central reasons:[2]

1. The fund managers generally do not contribute significant capital of their own. A key to determining whether income earned is appropriately considered a capital gain is whether the taxpayer has a capital stake. For the most part, these managers bring expertise to the table, not capital. To the extent that these managers invest capital they would qualify for capital gains treatment, this does not mean they should get preferential capital gains treatment for the compensation they receive for the services they provide.

2. The managers are paid handsomely because they provide important services. These fund managers are not passive investors (and may not be investors at all). They occupy the role of general partners and take a very active role in managing their investments. They often sit on the boards of companies in which they invest and are heavily involved in day-to-day decisions. A key player in the market – the Blackstone Group – summed it up well in a filing with the Securities and Exchange Commission (under the Investment Company Act of 1940). Blackstone explained to the SEC, "We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services."[3] It is a basic tenet of tax policy that compensation for services rendered should be taxed as *ordinary* income — not capital gains — no matter how important the services may be.

In the past, the industry has argued that its compensation is special because it is risky. One would hope that current widespread evidence of risk *throughout* the economy would put this argument to rest. Lots of compensation is risky, but this is not relevant to how it should be taxed.

Given the weakness of this argument, the industry may argue that any tax change would run the risk of disrupting financial markets. This is a harder case to make now that the government has advanced trillions of dollars to protect the economy from the fallout of dubious financial service sector practices. It seems difficult to argue in the current context that financial market success and stability hinges on keeping in a place a tax loophole for leverage buyout specialists.

Finally, tax policy decisions are often very difficult because they pose a choice between equity and economic efficiency. In this case, there is no such dilemma. The House's carried interest provision promotes both equity and efficiency. Currently, the income that people at firms like the investment

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[2] See Aviva Aron-Dine, "Myths and Realities About Changing the Tax Treatment Of Private Equity Fund Managers," November 8, 2007. http://www.cbpp.org/files/11-8-07tax.pdf.

[3] Cited in Citizens for Tax Justice, "Myths and Facts About Private Equity Fund Managers — and the Tax Loophole They Enjoy," July 2007, http://www.ctj.org/pdf/privateequity071907.pdf.

bank Goldman Sachs receive for providing essentially the same kind of services as private equity fund managers is taxed as ordinary income, not at the preferential capital gains rate that applies to income earned by the fund managers. It is not equitable for people receiving the same income for services they provide to face different tax rates on that compensation; nor is it efficient for the tax code to provide an incentive for a talented Goldman banker to jump to the Blackstone Group in order to take advantage of an unwarranted preferential tax rate.

Offshore Bank Accounts and Compliance

Recent efforts by the IRS and Treasury have highlighted a serious longstanding tax compliance problem: many wealthy Americans have established secret offshore bank accounts to evade taxes in the United States. The IRS established an amnesty-like program that allowed these wealthy tax evaders to avoid possible criminal prosecution and some penalties if they came forward with their account information by October 15th of this year. A higher-than-expected 14,700 wealthy Americans came forward.

To build on this compliance effort, the House tax extenders bill incorporates key elements of the Foreign Account Tax Compliance Act (HR 3933 and S 1934), which is sponsored by senior Democratic taxwriters including House Ways and Means Committee Chairmen Charles Rangel (D-NY) and Senate Finance Committee Chairman Max Baucus (D-MT), as well as by Representative Richard Neal (D-MA) and Senator John Kerry (D-MA). Such provisions include:

- *Foreign Bank Reporting Requirement*: foreign financial institutions would have to provide the IRS with information on accounts of U.S. individuals, as well as information on holdings of shell corporations. Foreign institutions that refuse to provide such information would face a 30 percent withholding tax on income from certain U.S. held assets.

- *Reporting Requirement for American Account Holders*: U.S. taxpayers who have foreign accounts in excess of $50,000 would have to provide account information on their tax returns or face certain penalties.

- *Longer Statute of Limitations*: a relevant statute of limitations around the underreporting of income on foreign assets would grow from three to six years to give the IRS more time for enforcement efforts.[4]

Next Step: Senate Should Pay for Its Tax Extender Bill, Too

The Senate should make clear that it will not pass the tax extenders bill unless its costs are fully offset. In addition, the Administration should make clear that it will not accept such a bill that is not paid for (or that contains offsets that could undercut the economic recovery). Given the soundness on policy and economic grounds of the offsets in the House bill, the Senate should give serious consideration to accepting them.

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[4] Summary of H.R. 4213, "Tax Extenders Act Of 2009," House Committee on Ways & Means, December 8, 2009. http://waysandmeans.house.gov/media/pdf/111/Extenders_Summary.pdf.