Tax Reform:

Restoring Economic Growth through Neutrality and Simplicity


AMERICANS FOR PROSPERITY

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Americans for Prosperity (AFP) is a nationwide organization of grassroots citizen-leaders committed to advancing every individual's right to economic freedom and opportunity. AFP believes reducing the size, scope and intrusiveness of government is the best way to achieve prosperity for all Americans. AFP is particularly interested in tax reform because of the tremendous opportunities it provides to reinvigorate economic growth, empower individuals and business to control more of their own money, and restore international competitiveness.

Many of the provisions that AFP analyzes in this paper are as old as the income tax code itself and thus have embedded political constituencies that will certainly fight to keep their tax benefits. AFP encourages Congress to take bold steps to reform, simplify and create neutrality in the federal tax code. In this paper AFP recommends the elimination of numerous tax provisions and counsels for the expansion of others. Our motivations are to create a simple, flat and neutral tax code with the fewest distortive, secondary effects on the economy. Areas that are particularly ripe for reform include: the treatment of savings and investment on both the personal and corporate side, the treatment of international corporate earnings, energy tax provisions that seek to pick winners and losers and numerous itemized deductions in the personal tax code.

Changing the treatment of many of these provisions in isolation will undoubtedly result in a tax increase. AFP's comments in this paper are meant to suggest items that Congress should reform in the context of comprehensive tax reform that lowers rates and gets rid of special, targeted provisions. Ending these deductions, credits, and exclusions without simultaneously lowering rates would be a tax increase, and AFP would likely oppose such a proposal. However, comprehensive reform offers an opportunity for Congress to clean up the code and reinvigorate economic growth all in one fell swoop, without increasing the net burden on taxpayers.

1. Charitable & Tax-Exempt Organizations

1.1. Gift Tax

In 2011, organizations structured under Section 501(c)(4) of the IRS Code were alarmed to hear that the Internal Revenue Service had changed policy and was applying the gift tax provisions of the IRS Code to contributions given to 501(c)(4) organizations.[1] In fact, the IRS had begun investigating donors who had given to a 501(c)(4) organization and reportedly had not paid a gift tax of 35% at that time.

After a public uproar, the IRS suspended applying the gift tax to contributions to 501(c)(4) organizations and closed open investigations.[1] However, IRS has not ruled out applying the tax in the future. There are over 100,000 organizations impacted by this decision, all dedicated to social welfare purposes. The threat of federal gift tax liability would harm the ability of these organizations to serve the public by deterring or reducing contributions from supporters.[2] As recipients of contributions, social welfare organizations would be liable for the gift tax if the IRS began applying it to contributions to 501(c)(4) organizations and the donor did not pay the tax. This would have a severe impact on the financial condition of each of these social welfare organizations if they had to pay the gift tax, which is 40% in 2013.

For almost 40 years, the IRS has not applied the gift tax provisions against contributions to 501(c)(4) organizations. While the IRS has suspended current plans to do so, it has reserved the right to do so in the future. AFP urges Congress to clarify this issue so that IRS does not make a policy change that was not intended when the gift tax was incorporated into the code and will have severe financial impact on so many worthy charitable organizations.

2. Debt, Equity & Capital

2.1. Business Expenditures: Expensing and Capitalization

The current mantra surrounding tax reform is that Congress should "reduce the rates and broaden the base." AFP believes that this goal is well intentioned but misguided. Congress should not be trying to simply broaden the base; it should be working to create a tax code with a neutral base.

2.1.1. A Neutral Tax Base

A neutral tax code is one that raises the necessary funds for government with the fewest distortions or secondary effects on the economy. This principle of taxation is critical "if the economy is to operate at peak efficiency, and if incomes are to be as high as possible."[3] A neutral base is one that does not discriminate between savings and consumption and also does not favor different types of activities within savings and consumption. "That can be accomplished by treating savings and investment as costs of earning income."[4] Such treatment helps "minimize the efficiency losses associated with income taxation."[5] Currently, the federal tax code contains numerous biases against savings and investment.

One area where the code needs dramatic improvement is the current treatment of business expenditures. Today, the general rule

[1] Letter from Steven T. Miller, Deputy Commissioner for Services and Enforcement, Internal Revenue Service, *Guidance for SB/SE Estate and Gift Tax and TE/GE/ Exempt Organizations*, July 7, 2011.

[2] Bureau of National Affairs, *Daily Tax Report, Exempt Organizations: IRS Answers Few Questions Regarding Audits of Donors Giving to Section 501(c)(4) Groups*, May 16, 2011.

[3] Stephen J. Entin, *Reforming Taxation: Advantages of a Saving-Consumption Neutral Tax Base, and Principles to Guide Reform*, Institute for Research on the Economics of Taxation, Feb. 16, 2005, at 5.

[4] *Id.*

[5] Gary Guenther, *Section 179 and Bonus Depreciation Expensing Allowances*, Congressional Research Service, RL31852, Sept. 10, 2012, at 16.

is that businesses may expense (i.e., deduct from their taxable income in the first year) any expenditure that was "ordinary and necessary … during the taxable year [while] carrying on any trade or business."[6] Conversely, businesses must capitalize (i.e., deduct from their taxable income in future years according to the depreciation/amortization schedules) expenditures that accrue assets to the business that will produce income outside of the current taxable year. The basic distinction between expensing and capitalizing is whether the business expenditure was consumption (expensed) or investment (capitalized). This delay in allowing businesses to deduct their cost of investment is a distortion that discourages investment.

This basic flaw in the tax code's treatment of business expenditures must be remedied. Unfortunately, over time provisions get cemented into law and even commonsense efforts to remedy substantial flaws draw inappropriate labels.[7] For example, there are numerous provisions throughout the code that attempt to mitigate the disincentive to invest created by the capitalization rules. Section 179 provides an election for certain depreciable asset expenditures to be immediately expensed, and section 57 outlines rules for intangible drilling costs. These provisions, and many others, are considered so-called "tax expenditures" by the Joint Committee on Taxation.[8] However, what they really are is an admission that our current system does not treat capital investments correctly. Even a small shift in a depreciation schedule (say, for corporate aircraft from 7 to 5 years) can draw a president's rancor and much media attention.

All of these special provisions could be erased from the code if we simply allowed businesses the option to immediately expense all of their "ordinary and necessary" expenditures regardless of the life of the asset.

2.1.2. Current Structure Encourages Market Distortions

The current non-neutral treatment of capital investments encourages several different types of market distortions, including: overstating income, preferences for certain geographic regions, high compliance costs due to unnecessary complexity and temptations for Congress to use expensing rules to manage the economy. The impact of these various distortions is not without economic impact. In fact, the economy could be sacrificing as much as 2.7% of GDP and 2.3% of wage growth because of the distortions that discourage businesses from making investments in capital plant and worker productivity.[9]

2.1.3. Overstating Income

Forcing companies to capitalize investments according to depreciation schedules overstates income. For each year that a business is not able to claim the full value of its expenditure it is essentially overstating its taxable income for that year. Additionally, as depreciation schedules push the deduction out into future years the value of the deduction decreases in value due to inflation. For example, "the value of the depreciation allowance on a seven year asset at three percent inflation is only 85 cents [on the dollar]. The allowed tax cost of a building that must be written

[6] 26 U.S.C. § 162(a).

[7] Some commenters still incorrectly argue that "By lowering the cost of capital, accelerated depreciation benefits capital-intensive industries over relatively labor-intensive industries," Jeremy Horpedahl and Brandon M. Pizzola, *A Trillion Little Subsidies*, Mercatus Center at George Mason University, Oct. 24, 2012, at 22, available online: http://mercatus.org/sites/default/files/TaxExpenditures_Horpedahl_v1-0.pdf. This argument ignores that under the current system the opposite is in fact happening: Capital is disadvantaged relative to labor (which is expensed) thus shifting the economy away from capital investment and toward labor-intensive industries.

[8] Joint Committee on Taxation, JCS-1-13, *Estimates of Federal tax Expenditures for Fiscal years 2012-2017*, Feb. 1, 2013.

[9] *Tax Reform Options: What Changes Would Generate the Greatest Growth for the Money, Before the J. Econ. Comm.*, 112th Cong. (2011) (statement of Stephen J. Entin) Table 4 at 13.

[off] over 39 years is only 37 cents [on the dollar]."[10] Thus by the end of the depreciation not only has the business been overstating its income each year, but it never fully recaptures the economic value of the expenditure in an appropriately reduced tax liability. This treatment discourages companies from investing in their businesses, denying their workers and the overall economy the increased productivity those capital investments would bring.

2.1.4. Playing Favorites: Geographic Provisions

One distortion that arises from targeted and preferential expensing provisions is that Congress often provides these provisions in certain favored geographic regions. For example, in the Community Renewal Tax Relief Act of 2000, Congress designated "renewable communities" for enhanced expensing allowances. In 2002, Congress created the New York Liberty Zone to encourage and assist businesses in rebuilding from the 2001 terrorist attacks. In 2005, Congress added the Gulf Coast Opportunity Zone to the list of favored geographic regions in order to mitigate the rebuilding costs following Hurricane Katrina.[11] The fact that Congress felt the need to privilege these areas was no doubt based on a desire to help them recover from economically damaging events. However, it's also an admission that the current tax treatment of capital investment was discouraging the private sector from doing so on its own. Instead of using the tax code to preference certain geographic regions, Congress should adopt a treatment of capital investment that is uniform, permanent and neutral, such as immediate first-year expensing for everyone.

2.1.5. Capitalization Rules are Unduly Complex

Complying with our burdensome tax code is one of its great inefficiencies. In 2008, on the business side alone this complexity required 2.94 billion hours of compliance work costing the economy over $160 billion.[12] The Office of Advocacy at the Small Business Administration reported that this complexity is regressive relative to the size of the firm, as small businesses are ill-equipped to deal with the associated costs.[13] Much of the complexity is due to the labyrinthine expensing and depreciation rules. According to the IRS Office of the Taxpayer Advocate, small businesses "face a particularly bewildering array of laws, including a patchwork set of rules that governs the depreciation of equipment."[14] These hurdles include the method of depreciation (straight line, double declining, accelerated, etc.), salvage value, useful life of the asset, asset classification, date-placed-in-service issues, length of recovery periods and many more.

None of this complexity is necessary. Immediate expensing means businesses spend less time and administrative cost complying with the code and more on their core capabilities. However, when the accelerated allowances are temporary and targeted as opposed to permanent and universal, "the rules governing the use of the allowance add a layer of complexity" to the code.[15]

Unfortunately, while many commenters involved in tax reform recognize that there is unnecessary complexity and ill-aligned incentives in the code, some do not recognize that the non-neutral treatment of saving and

[10] Entin, *Reforming Taxation*, *supra* note 3 at 12, 14.
[11] Guenther, *supra* note 5, at 5-6.
[12] Arthur B. Laffer, Wayne H. Winegarden and John Childs, *The Economic Burden Caused by Tax Code Complexity*, The Laffer Center, Apr. 2011, at 3, available online: http://www.laffercenter.com/wp-content/uploads/2011/06/2011-Laffer-TaxCodeComplexity.pdf.
[13] W. Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms*, Office of Advocacy, Small Business Administration, 2001.
[14] Internal Revenue Service, Taxpayer Advocate Service, *2008 Annual Report to Congress, MSP #1, The Complexity of the Tax Code*, at 10, available online: http://www.irs.gov/pub/irs-utl/08_tas_arc_msp_1.pdf.
[15] Guenther, *supra* note 5, at 18.

investments is the source of these ills. For example, the Bowles-Simpson report noted: "the U.S. corporate tax is a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment."[16] However, the report's recommended corporate tax reforms urge Congress to broaden the base and eliminate so-called "tax expenditures" including the immediate expensing of businesses' cost of investing in their capital plant. This recommendation correctly diagnoses the symptoms but misidentifies the disease and thus prescribes the wrong medicine.

2.1.6. Manipulating the Cost of Capital as "Stimulus"

Another troubling aspect of the current expensing and capitalization rules is that they tempt Congress to meddle in the economy. Congress frequently attempts to incent business investment by allowing accelerated depreciation for certain politically favored groups, like small businesses. Jeremy Horpedahl and Brandon Pizzola from the Mercatus Center at George Mason University note: "There is an incentive to replace capital goods more often under accelerated depreciation than under either a straight-line or 'true' depreciation schedule. The more a depreciation schedule is weighted toward the early years of an asset's life, the lower the cost of purchasing that good."[17] When Congress uses targeted accelerated depreciation rules it is a tacit admission that the current capitalization requirements are delaying investments. The Congressional Research Service points out that since 2002 there have been six bills with bonus depreciation or enhanced expensing allowances "intended, in part, to spark an increase in small business investment, as part of a broader government effort to stimulate the economy."[18] Why should we have a tax code that delays investment just so that Congress can push that investment forward when it feels the economy needs a jolt? These types of political interventions and market planning tools are examples of what is currently weighing down our economy.

Not only is the current treatment of business expenditures delaying investment, but evidence suggests that Congress's intended acceleration of that investment may not even work as planned. For example, the section 179 allowance is intended to benefit small businesses but "the design of the allowance, especially the phaseout range, sharply limits its potential to affect economic activity."[19] The allowance also does not reach all types of capital investment, denying proper treatment to land, inventories and structures.[20] This "drives a wedge between favored assets and all other assets regarding their profitability."[21] Additionally, because of their temporary (or perceived temporary) nature, such provisions may not spur new investment but instead simply reward firms that were in the process of making the investments anyway. A permanent, neutral treatment of all capital investment would ameliorate all of these failures.

Even worse, once Congress begins to pick and choose which depreciations it wants to accelerate it often finds itself on both sides of issue. For example, in Senate Budget Committee Chairman Patty Murray's FY2014 budget, she both praises Congress for passing "18

[16] National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, Dec. 2010, at Section 2.2, available online: http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.
[17] Horpedahl & Pizzola, *supra* note 7, at 22.
[18] Guenther, *supra* note 5, at 11.
[19] *Id.* at 13.
[20] *Id.*
[21] *Id.* at 15.

direct tax breaks for small business … [including] 100-percent expensing of new investments." But she also maligns that the country "simply can't afford to continue the practice of giving billions of dollars in wasteful tax incentives . . . such as the special depreciation rules enjoyed by corporate jet owners."[22] This attempt by Congress to support proper tax treatment for some businesses but repudiate it for others is at the root of our economic malaise and the inefficiency of our tax code.

2.1.7. Conclusion

Establishing a neutral tax base is a critical component of tax reform if Congress is to restore economic growth and maximize efficiency. Resolving the current incorrect treatment of savings, particularly business investment, is central to that challenge. Congress can begin to take measureable steps in the right direction by permitting businesses to correctly compute their taxable income by allowing them to fully expense the cost of "ordinary and necessary" business expenditures in the taxable year in which they occur. This treatment will likely create considerable net operating losses (NOL) for businesses during startup or in years where investments outpace revenues. The code currently allows some NOL carryforward, although there are limits[23] and unincorporated businesses and Subchapter S corporations do not benefit. Congress should allow businesses that incur NOLs by full expensing to carry them forward until exhausted.

2.2. Indexing Basis for Capital Gains

Capital is traditionally understood to be synonymous with money or cash, but economically, capital is a much larger category. Capital could be a liquid asset, but also items such as stocks, bonds, factories, machinery and illiquid financial instruments. Capital formation is essential for economic growth. According to analysis from Harvard Economist Dale Jorgenson, half of all economic growth in the United States from 1948 to 1980 was spurred by capital formation.[24]

Taxation of capital gains has dramatic effects on economic growth. As so many economists have explained, by taxing an activity, less of it is surely to take place. This recognition is also bipartisan. In 1963, President John F. Kennedy said: "The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital . . . the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."[25]

Currently, long-term capital gains for individuals are taxed at a rate of 15% or 20% depending on the taxpayer's income. Some high-income taxpayers pay an additional 3.8% surtax on capital gains. This section of the tax code is tackled in another section of AFP's comments.[26] This tax is recognized for tax purposes at the time of sale allowing the taxpayer to defer his tax liability. Individuals must include the full value of their capital gains on their tax return, but are capped to $3,000 in capital losses during any one tax year. Losses may carry forward to future tax years.

[22] Nicole Kaeding, *Democrats Want it Both Ways on Taxes*, Americans for Prosperity, Mar. 15, 2013, available online: http://americansforprosperity.org/legislativealerts/democrats-want-it-both-ays-on-taxes/.

[23] 26 U.S.C. § 382.

[24] Stephen Moore and John Silvia, *The ABCs of the Capital Gains Tax*, Cato Institute, Policy Analysis No. 242, available online: http://www.cato.org/sites/cato.org/files/pubs/pdf/pa242.pdf.

[25] Moore & Silvia, *supra* note 24.

[26] *See* discussion *infra* Part 2.5.

There are important exceptions to the capital gains tax in the U.S. particularly related to the sale of a primary residence. The first $500,000 in capital gain from the sale of a primary residence by joint filers is excluded from filers' gross income.[27]

For illustration of the capital gains tax, suppose an individual's initial investment in stock ABC was $1,000. Ten years later, ABC stock is sold for $2,000 returning the $1,000 initial investment and a $1,000 gain. The individual would be taxed 20%, the current capital gains tax rate, on the $1,000 gain meaning $200 in revenue for the federal government.

Unfortunately under our current capital gains tax system, allowances are not made for inflation meaning individuals are taxed on non-real gains. This has consequential effects on the formation of capital within the United States. AFP supports indexing the capital gains basis to inflation.

Based on the example above, let's further assume that inflation was 25% during the investment period. This means the original investment of $1,000 was actually worth $1,250 at the time of sale, reducing the real (inflation-adjusted) gain from $1,000 to $750. Even more devastating, it is possible that an individual could be taxed on a negative real return. If inflation had grown 100% during that ten-year period, the individual would have had a $1,000 nominal gain, but a $0 real gain. The individual would still owe $200 in federal capital gains taxes.

This means individuals end up paying effective tax rates well above the statutory capital gains tax rate. Functionally, the capital gains tax is two separate taxes. First, it is the statutory capital gains tax of 20%. Second it is a "wealth tax on asset holdings with a rate equal to the product of the capital gains tax rate and the inflation rate."[28]

This effect punishes individuals for engaging in proper investment techniques – buying and holding assets for long periods. Numerous other countries provide some sort of accommodation to taxpayers to avoid this very issue acknowledging that it is a real problem. Some don't tax capital gains at all, the ideal solution. However, other OECD countries provide either a capital gains exclusion or allow the taxpayer to adjust their basis in relation to some inflation measure, like consumer spending.

Transitioning to a tax structure in which the capital gains basis is indexed to inflation has been discussed for over twenty years, yet Congress continues to fail to act. AFP believes strongly that individuals should only be taxed upon their real capital gains, not on nominal gains. We further believe that indexing should be added to the current regime that recognizes capital gains should be taxed at a lower rate than ordinary income. The tax literature is replete with reasons why under an income tax capital gains should receive a lower rate, including: the lock-in effect, time value of money, double taxation and exposure to risk of loss.

2.3. The Death Tax

The federal government imposes an estate tax—commonly referred to as the "death tax"—

[27] 26 U.S.C. § 121.

[28] Josh Barro, *It's a Good Time to Index Taxes on Capital*, Manhattan Institute, Aug. 31, 2010, available online: http://www.manhattan-institute.org/html/miarticle.htm?id=6487#.UVLzrByG2U8.

on the transfer of assets of any citizen or resident of the United States upon death. The death tax is imposed on the estate of the decedent and generally is based on the fair market value of the assets. The tax is levied against and paid by the estate. In current law, this tax is levied at a top rate of 40 percent with a $5.25 million exemption.[29] Individuals can leave an unlimited amount tax-free to a surviving spouse or charity. Many states levy a death tax in addition to the federal one, although many attempts at repeal on the state level are ongoing.

2.3.1. Recent Legislative History

The death tax's rate and basis has fluctuated dramatically in recent history. The top rate was 55 percent and the exemption was $1 million in 2001. The Bush-era tax cuts reduced the death tax between 2002 and 2010, including a full repeal in 2010. In 2010, Congress adjusted the death tax for 2011 and 2012 by raising the exemption level to $5 million and lowering the top rate to 35 percent.

The death tax was scheduled to revert back to a $1 million exemption and a 55 percent top tax rate at the start of 2013. But the American Taxpayer Relief Act of 2012, the so-called fiscal cliff deal that included a number of tax changes at the start of January 2013, permanently extended nearly all of the 2010 Tax Act parameters of the death tax, except for the top tax rate on taxable estates, which rose from 35 to 40 percent. It also indexed the exemption to inflation.

Proponents of the death tax cite three main reasons to continue taxation on death. They claim that the tax: raises a significant amount of revenue for the government, increases charitable giving due to the allowable deduction from death tax liability and that it breaks up large concentrations of wealth. As it turns out, all three claims are not rooted in reality.

2.3.2. Generating revenue

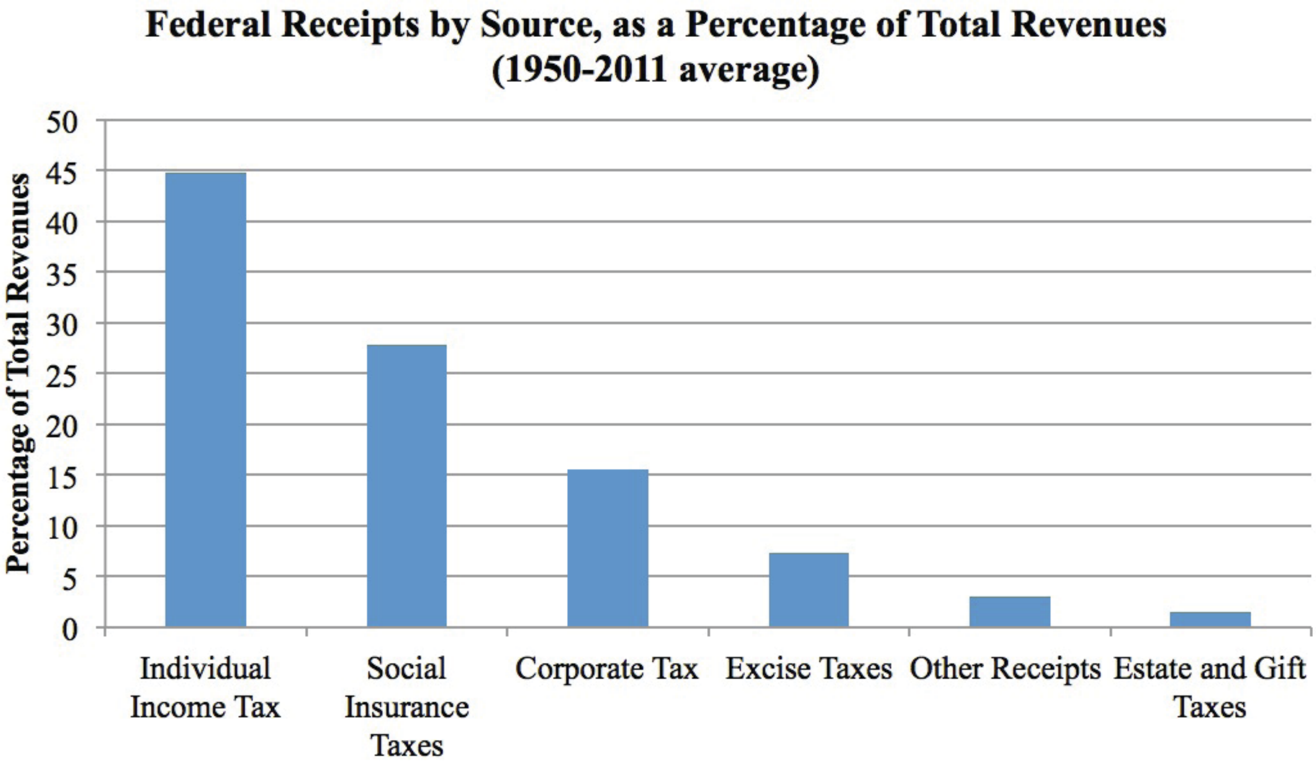
Advocates of the death tax see it as a way to generate revenue for the federal government, but historical revenue data show that it is an insignificant source. Death taxes contribute a paltry 1-2 percent to total federal revenue every year.[30] Over the period from 1950 and 2011, the death and gift taxes produced only 1.5 percent of revenue. In addition, research cited by the Tax Foundation shows that the compliance costs of the federal death tax are approximately equal to the amount of revenue it generates, negating any revenue generated by the tax.[31]

Moreover, the revenue assertion relies on the dubious assumption that the death tax distorts no other aspects of the economy. Evidence shows that this too is false. To the contrary, much evidence suggests that eliminating the estate tax would increase federal revenue. One way this could happen is by higher revenues from other types of taxes, such as the income tax and higher capital gains revenue as taxpayers stop trying to avoid the tax at death.

[29] 26 U.S.C. § 2001.

[30] The White House Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2013*, Historical Tables.

[31] *Economic Effects of the Estate Tax*, *Before the Pa. House Fin. Comm.* (Oct. 17, 2011) (statement of David Logan), citing Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes,* New Eng. Econ. Rev., Nov./Dec. 1988, at 19, available online: http://taxfoundation.org/article/economic-effects-estate-tax-testimony-david-s-logan-pennsylvania-house-finance-committee#_edn4.



Source: Joint Committee on Taxation[32]

2.3.3. Charitable giving

Proponents also claim that death taxes lead to higher rates of charitable giving, but this is also not true. Looking at the data, charitable giving isn't affected when the death tax rate changes. Back in 2003, when the Bush-era tax cuts went into effect, some economists predicted that charitable contributions would fall between 22 percent and 37 percent if the federal death tax was repealed.[33] However, IRS data does not match up with these predictions. After 2003, even as the federal exemption continued to climb during the phase-out of the tax, contributions remained steady for charitable organizations and increased for private foundations, even when adjusted for inflation.

This argument is based on the assumption that tax breaks are the sole motivator for charitable giving and is at odds with studies' revelations about the basis of charitable giving. In numerous studies, including one by the American Enterprise Institute's President Arthur Brooks, scholars find that charitable contributions are most often made for religious and altruistic reasons.[34]

2.3.4. Wealth redistribution

A third common argument supporting death taxes is that they are necessary to reduce economic inequality. First, this argument is philosophically inapposite to the principles of limited government and free markets (i.e.,

[32] Joint Committee on Taxation, *Overview of The Federal Tax System As In Effect For 2012*, Feb. 24, 2012, available online: https://www.jct.gov/publications.html?func=startdown&id=4400.

[33] Jon M. Bakija and William G. Gale, *Effects of Estate Tax Reform on Charitable Giving*, Urban-Brookings Tax Policy Center, Tax Policy Issues and Options, No. 6, July 2003.

[34] Arthur C. Brooks, *The Culture of Charity*, 17 Action Inst.'s Religion & Liberty J. 2 (2007), available online: http://www.acton.org/pub/religion-liberty/volume-17-number-2/culture-charity.

the government should not use the tax code to redistribute wealth). Second, the death tax is also woefully ineffective at accomplishing this goal. Although proponents hope death taxes prevent wealthy families from passing on wealth on to future generations, the effects of the tax reach a greater number of people than its proponents intend, including middle-income Americans.

The impact of the tax is seen throughout the economic spectrum, resulting in a number of unintended consequences. High-wealth taxpayers know that the death tax will affect their estate, so they have time to plan and hire advisors to limit the tax's impact. However, middle-income people and businesses may be surprised when they get hit by the tax. Furthermore, studies from the Treasury Department demonstrate that economic status is constantly churning—with lower income taxpayers being highly mobile, and the wealthy not remaining in the uppermost tier for very long.

2.3.5. It is Time to End the Federal Death Tax

Death taxes impose a number of costs on the American economy. There is a library of research on the myriad ways that the tax distorts economic decision making, increases overall tax compliance costs, is unduly complex and slows economic growth.

First, the death tax stifles economic growth by discouraging saving and investment. It gives individuals an incentive to shift their behavior toward consumption and away from saving and investing because the death tax will capture as much as 40 percent of their assets above the exemption. The Joint Economic Committee estimates that without a death tax the total capital stock in the U.S. today would be 3.8 percent higher—in other words, one trillion additional dollars would be available to invest in new facilities and equipment and to hire and train new employees.[35]

Second, the death tax is associated with significant tax compliance costs, which also drag on the economy. Compliance alone consumes significant amounts of capital, time and labor. These resources are absorbed by financial estate planners, enforcement and administrative responsibilities created by the tax. Rather than pouring resources into these areas, overall welfare would improve if Americans were able to expand their businesses or support their descendants instead.

Third, the death tax burdens Americans all along the economic ladder, not just the wealthy. The vast majority of American small business and farm owners must attempt to rectify their death taxes without estate planning assistance. Too often, this results in drastic cost cutting in a family business, or a loss of the business entirely. Since death taxes are owed to the government by the recipients of the estate, those recipients are often forced to sell property or the business in order to pay the tax, in the event that they lack the necessary funds. This has a real impact on jobs: Former Congressional Budget Office Director Douglas Holtz-Eakin estimates that the current death tax has destroyed over 850,000 jobs.[36] It also impacts private capital: The Joint

[35] Joint Economic Committee, *Costs and Consequences of the Federal Estate Tax*, May 2006.
[36] Douglas Holtz-Eakin and Cameron T. Smith, *Growth Consequences of Estate Tax Reform: Impacts on Small and Family Businesses*, American Family Business Foundation, Sept. 2010.

Economic Committee found that the death tax has reduced the capital stock by approximately $1.1 trillion since it was enacted.[37]

In particular, studies routinely find that death taxes discourage entrepreneurship. Tax Foundation research shows that the federal death tax has approximately the same effect on entrepreneurial incentives as doubling the income tax.[38] An entrepreneur (e.g., a small business proprietor, a family farmer) tends to collect a wealth of business assets and personal wealth over his lifetime—the knowledge that the federal government will take as much as 40 percent from the estate significantly reduces his incentive to develop his businesses. Entrepreneurial activity is something the government should seek to encourage, not discourage through taxes.

Not only is the estate tax bad economics it's bad principle, too. It is simply immoral to punish Americans who work and save throughout their lives by confiscating the fruits of their labor when they die. The death tax punishes people who work hard, become successful and want to pass on their assets to their children.

2.3.6. Conclusion

Amid concerns over the propensity of Americans to spend and the need to save, a tax that directly punishes those who save is highly detrimental. The Founding Fathers considered seizing estates so pernicious they even forbade it for those convicted of treason; yet today the same effect is achieved through the tax code and imposed on those who have merely achieved the American dream.

The death tax should be eliminated. This would install a straightforward reform that protects the nation's family farms and family-owned businesses from double taxation, simplifies the tax code, reduces administrative and compliance cost and makes the U.S. more attractive to foreign investments—all with negligible impact to federal revenues.

2.4. Differential Tax Treatment of Debt and Equity

The federal government treats debt and equity differently in terms of taxation. Under the current system, corporations can deduct interest payments incurred in debt financing from their taxes.[39] However, they cannot deduct the cost of issuing equity to shareholders, serviced in the form of dividend payments.

The difference in effective rates is striking: A 2005 Congressional Budget Office report found that companies face an effective tax rate of 36.1 percent when they finance with equity, and they face a negative effective tax rate of 6.4 percent when they finance with debt.[40] A 2007 Treasury Department report concluded that the effective marginal tax rate for equity-financed investment is 39.7 and debt-financed investment is -2.2 percent.[41] That essentially means that the tax code is subsidizing taking on more debt. Treasury also noted that the U.S. had the largest disparity between debt and equity effective marginal rates in the OECD.[42]

[37] Joint Economic Committee, *Cost and Consequences of the Federal Estate Tax*, July 25, 2012, available online: http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=bc9424c1-8897-4dbd-b14c-a17c9c5380a3.

[38] J. D. Foster and Patrick Fleenor, *An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship*, Tax Foundation, June 1, 1994, available online: http://taxfoundation.org/article/analysis-disincentive-effects-estate-tax-entrepreneurship.

[39] *See generally*, 26 U.S.C. § 163.

[40] Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform*, Oct. 1, 2005, available online: http://www.cbo.gov/publication/17393.

[41] U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007, at 81, available online: http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf.

[42] *Id.*

The preference for debt arises not necessarily from the interest deduction – which many argue is an appropriate business expense[43] – but from the double taxation of corporate equity. Corporations that equity finance expose the same dollar to double taxation – first under the corporate income tax and a second time under the individual income tax as a dividend or capital gain. Meanwhile, corporations that use debt financing are allowed to deduct their interest payments from their tax liability, leaving only the single level of tax paid on the party receiving the interest payment.

2.4.1. Economic Costs of Differential Treatment

The favorable tax treatment of debt over equity brings many harmful results. The most common concern is the economic efficiency of financial markets. Additional problems include higher compliance and administrative costs, as well as the question of the appropriate role of government in influencing corporate behavior.

First, the difference in tax treatment is economically inefficient because it directly influences companies to change their resource allocation and financing decisions.[44] Corporations often decide to finance a certain project with debt instead of equity solely because it will limit their tax liability. This means that companies will take on higher levels of risk and debt than they would otherwise, leading many to become overleveraged. This has harmful unintended economic consequences such as threatening the stability of financial markets. It makes the overall economy more vulnerable to future financial crises.

Another problem with treating debt and equity differently is the lack of simplicity and high costs of compliance. One of the advantages of a simpler tax code is lower costs of compliance. Under a neutral tax code, businesses tend to devote fewer resources toward tax planning. If the tax treatment between debt and equity were neutral, then businesses would be able to pursue the combination of debt and equity financing that makes the most sense for their business, not those that simply minimize their tax liability.

2.4.2. Two Paths to Resolution

There are two ways that Congress can close the gap between debt and equity. Congress can either reduce the tax burden on equity by allowing corporations to deduct dividends or it can reduce the tax advantage of corporate debt by limiting the interest-paid deduction. The simplest way to reduce the tax burden on equity would be to allow businesses to deduct the cost of servicing equity: deducting the cost of paying dividends.[45] This would remove the double taxation and bring the effective marginal rate on equity financing closer to that on debt financing.

As an alternate solution, Congress could limit the tax deductibility of interest payments. The 2007 Treasury Department report suggests a few ways to do so:

"By denying the deduction for interest, this approach would subject income from debt-financed investments to the corporate income tax. It would also remove completely any taxation at the corporate level

[43] J.D. Foster, *WaPo Fails Tax Policy 101*, Heritage Foundation, Aug. 9, 2010, available online: http://blog.heritage.org/2010/08/09/wapo-fails-tax-policy-101/.

[44] *See generally*, Robert Pozen, *Corporate-Tax Reform Without Tears*, Wall Street Journal, Mar. 31, 2013.

[45] Treasury, *supra* note 41, at Chapter 2.

of interest and dividends received from other domestic corporations; the income represented by these payments would have already been taxed at the corporate level. As a result, both interest and corporate profits (whether retained or distributed) would be subjected to the same corporate tax burden."[46]

2.4.3. Conclusion

Debt and equity are both important financial tools, but the tax code should not encourage businesses to choose one over the other. The socially optimal level of debt is something that should be left to individual market participants, not the tax code, to decide. When comprehensively reforming the tax code, Congress should eliminate the favorable tax treatment of debt over equity that currently exists in the tax code in order to facilitate an environment for economic growth.

2.5. Surtax on Investment Income

Section 1401 of the Patient Protection and Affordable Care Act (PPACA) establishes a new tax called the "unearned income Medicare contribution" that establishes a new 3.8% surtax on "net investment income for any taxable year" effective January 1, 2013 for all single taxpayers above $200,000 and married filing jointly taxpayers earning more than $250,000.[47] The tax is the same rate as the payroll tax currently collected from high-income taxpayers to pay for Medicare funding. PPACA defines investment income to include rents, royalties, interest, dividends, annuities and capital gains. This tax is on top of the 20% capital gains tax rate and dividends tax rate or ordinary income tax rate; whichever is the most appropriate for the asset being taxed.

This tax violates the principles of sound taxation. Taxes should be flat with uniform rates across all taxpayers. Taxes should not target individuals based on their ability to pay. This surtax targets high-income taxpayers and is one of many instances of the current tax code charging higher rates for high-income taxpayers. Additionally, this tax adds unnecessary complexity to the tax code.[48] The tax is assessed on a new category of income called "unearned income." This categorization doesn't appear elsewhere in the tax code and is an odd mix of items with diverse tax treatments. It is needlessly complex to create a new group that includes items traditionally considered to be capital gains with items considered to be ordinary income.

The tax is actually charged by comparing the taxpayer's net investment income and their Modified Adjusted Gross Income (MAGI), which is itself a new formulation under PPACA. The surtax is charged on the lesser of the taxpayer's net investment income or the amount of MAGI that exceeds the $200,000 or $250,000 filing thresholds.[49]

This tax is in essence a new version of the Alternative Minimum Tax (AMT) forcing an additional calculation during tax preparation increasing compliance costs for taxpayers. Even more troubling, this section of statute also follows the flawed example of the AMT by not tying the filing thresholds to inflation, a flaw that has thankfully been fixed for the AMT. More and more taxpayers will be subject to this surtax moving it from targeting "high-income taxpayers" to hitting many middle-income families. As times moves on, families will be forced to comply with this complex, targeted tax hike.

[46] Treasury, *supra* note 41, at Chapter 4, Section B.
[47] Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1401, 124 Stat. 119 (2010) [hereinafter PPACA].
[48] Lydia Beyoud, *Obamacare Proves too Complicated for Accountants With IRS: Taxes*, Bloomberg Government, Apr. 4, 2013, available online: http://www.bgov.com/news_item/DSbiXRDptKnVsMS5kO7cVw.
[49] PPACA §1401 (a)(1).

AFP supports repeal of this burdensome tax provision.

3. Energy Taxation

3.1. Technology-Specific Subsidies

Numerous provisions in the tax code influence investment in energy production. The federal government uses these tax provisions to pursue a number of goals. These include, but they aren't limited to: controlling America's energy choices, picking winners and losers and providing favorable treatment for politically connected industries. In addition to expanding government control beyond its proper limitations, these interventions cause market distortions and unintended consequences. Their costs far exceed their benefits and they should be eliminated.

The federal government has tried to encourage the production of various energy technologies using a variety of methods, such as: providing special tax benefits, research and development funding, grants, loan guarantees, regulatory policies and more. It's long past time to focus on the favorable federal tax treatment certain technologies receive and the harm those provisions have on the economy.

3.1.1. Encouraging Economic Activity and Job Creation

Despite politicians' rhetoric claiming that green energy programs create jobs, the evidence speaks loudly to the contrary. In the public sector, subsidies for "green jobs" during a period of tremendous budget difficulties forces money away from other state programs like education and public safety. To consider an example from the states, Oregon granted over $160 million through the Business Energy Tax Credit from 2009 to 2011, while cutting K-12 education, eliminating courses and forcing the layoff of teachers.[50]

Lawmakers need to look beyond the propped-up payrolls. They need to consider the numerous unseen costs of subsidizing technology-specific energy industries. The jobs created under the auspices of these provisions are unsustainable and take away from other competitive industries that give a market struggling with employment the durable jobs essential to economic recovery. These jobs only exist because of government subsidies, and this money doesn't come out of thin air. In addition to their explicit cost, there is an oft-overlooked opportunity cost to targeted energy incentives. For example, if a wind turbine manufacturer can keep 100 additional workers on the payroll because it receives a tax credit, those 100 workers cannot work in productive sectors of the economy. And by diverting labor and capital away from more efficient uses, these energy incentives drag on the economy.

3.1.2. Infant Industry

Proponents of giving favorable tax treatment to certain industries often use the infant industry argument. They argue that certain segments of the energy industry need favorable tax treatment in order to get off the ground. The problem with this reasoning, as Nobel laureate economist Milton Friedman

[50] Brian Leonard, *Green Jobs Don't Grow on Trees*, State Budget Solutions, Mar. 7, 2012, available online: http://www.statebudgetsolutions.org/doclib/20120306_GreenJobsReport.pdf.

highlighted, is that these so-called infant industries rarely grow up. For example, consider the wind industry. The wind industry has been receiving subsidies for nearly 20 years, and yet it still remains woefully dependent on the tax credit instead of showing any signs of independent stability. In fact, in three years that the subsidies were allowed to lapse, the new wind farm installations fell by 93 percent[51] —proof that the industry isn't viable unless it is able to gain special tax provisions.

Another example is favorable tax treatment for ethanol. The first ethanol tax credit was introduced in 1978, but despite over 30 years of favorable treatment the ethanol industry has achieved little. Americans still rely on traditional sources of fuel and prices at the pump have recently skyrocketed. It's a problem with incentives: Companies have a strong incentive to remain dependent indefinitely on the government support.

3.1.3. The "fairness" argument

Proponents for tax incentives for renewable energies often claim that they're needed to complete with conventional sources. The claim that coal and nuclear get subsidies exceed those for renewable sources is completely false. Quite to the contrary, the wind and solar energy industries get the most federal subsidies per megawatt hour. According to the Energy Information Administration, government support per megawatt hour for natural gas, oil, and coal is 64 cents; nuclear $3.14; wind $56.29; and solar $775.64.[52] This should not be misconstrued as an argument supporting higher federal assistance for conventional sources; it is only to demonstrate that new technologies by far receive the highest subsidies.

3.1.4. Unintended consequences

As the Obama administration aggressively interferes in the nation's energy markets to pursue a "green" agenda, they seem to be ignoring the effects on American families and businesses—the pain felt by everyone when energy prices increase and government spending increases. The federal government's heavy-handed support for its favorite energy technologies has resulted in a number of unintended harmful consequences on the economy.

One of these consequences is higher energy costs. With a tax credit to support some of the most expensive kinds of energy, Americans pay for the increased cost of electricity first as taxpayers and then again as ratepayers. These subsidies will cause demand and therefore the price of a particular energy to rise. For example, if the taxes and subsidies were level across the energy industry, wind alone is 162% more expensive than the production of coal.[53] Renewable energy such as wind and solar power is also inherently unstable. Wind, for example, is not a consistent producer of energy and requires stand-by power to sustain the output of electricity. This alone increases the cost of production by 50%.[54] Although this is obviously good for the energy producers as it will drive up their sales and profits, but it's bad for businesses that use these energy sources in their production processes, and bad

[51] American Wind Energy Association, *Federal Production Tax Credit for Wind Energy*, available online: http://www.awea.org/issues/federal_policy/upload/PTC-Fact-Sheet.pdf.
[52] Wall Street Journal, *The Energy Subsidy Tally,* Review & Outlook, Aug. 17, 2012, available online: http://online.wsj.com/article/SB10001424053111903285704576559103573673300.html.
[53] Institute for Energy Research, *Energy Regulation in the States: A Wake-up Call*, available online: http://www.instituteforenergyresearch.org/pdf/statereport.pdf.
[54] *Id.*

for their customers who will face higher prices.

Another unintended consequence of government policies that favor ethanol is higher food costs. As we have seen with blending mandates for ethanol, diverting corn from food to fuel has increased food prices for everything from cereal to dairy to meat and poultry.[55] That's because blending mandates for ethanol encourages farmers to shift corn production away from food consumption and toward wasteful fuel blends.

3.1.5. Cronyism

Well-connected, well-organized special interests in the energy industry have a strong incentive to lobby Congress to keep the playing field tilted in their favor. This leads to policies that overwhelmingly benefit special interests at the expense of American taxpayers and citizens. This is a problem because it shifts the incentive structure: Companies have a stronger incentive to spend resources seeking special favors from Washington instead of innovating and improving business. Seeking subsidies becomes more profitable than developing new products that benefit consumers. Research from Peter Schweizer of the Hoover Institution highlights another aspect of the cronyism inherent in the government's green energy agenda: Fully 80 percent of renewable energy companies backed by the Energy Department were "run by or primarily owned by Obama financial backers."[56] This is a problem because it sets up a situation in which government awards lucrative handouts based on benefiting its friends and allies, not based on benefiting the economy.

3.1.6. Expense research and development

Congress should enact tax policy that allows for investment in developing energy technologies in a way that does not pick winners and losers. One way is to allow all energy companies—conventional, renewable, and all others—to recover their research and development costs by taxing only their net income. There is a big difference between appropriate expensing deductions and inappropriate targeted subsidies.[57] The former is a cost recovery mechanism that should be available to all businesses; the latter is a direct government incentive that can only be used by the favored few.

Under a regime that allows full expensing of research and development costs, companies would be free to explore new technologies, not limiting themselves to those that Washington has picked with favored tax treatment. New technologies would be able to compete for consumers' dollars on their own merits and on a level playing field, not by petitioning the government for special favors.

3.1.7. Specific tax incentives to eliminate

The following are technology-specific tax provisions that should be eliminated. These tax provisions have many features in common. First, instead of allowing for legitimate cost recovery, they simply encourage higher levels

[55] Wallace E. Tyner, Farzad Taheripour and Chris Hurt, *Potential Impacts of a Partial Waiver of the Ethanol Blending Rules*, Farm Foundation & Purdue University, Aug. 16, 2012 available online: http://www.farmfoundation.org/news/articlefiles/1841-Purdue%20paper%20final.pdf.
[56] Peter Schweizer, Throw Them All Out (2011).
[57] *See supra*, A Neutral Tax Base, Part 2.1.1.

of production. Second, their eligibility requirements are too narrow in scope to be enjoyed by anyone outside of the targeted industry.

- Advanced Biofuel Feedstock Incentives
- Advanced Biofuel Production Payments
- Advanced Energy Research Project Grants
- Advanced Technology Vehicle Manufacturing Incentives
- Alternative Fuel Excise Tax Credit
- Alternative Fuel Infrastructure Tax Credit
- Alternative Fuel Mixture Excise Tax Credit
- Alternative Fuel Tax Exemption
- Biodiesel Income Tax Credit
- Biodiesel Mixture Excise Tax Credit
- Ethanol Infrastructure Grants and Loan Guarantees
- Fuel Cell Motor Vehicle Tax Credit
- Hydrogen Fuel Excise Tax Credit
- Hydrogen Fuel Infrastructure Tax Credit
- Hydrogen Fuel Mixture Excise Tax Credit
- Idle Reduction Technology Excise Tax Exemption
- Qualified Plug-In Electric Drive Motor Vehicle Tax Credit
- Second Generation Biofuel Producer Tax Credit
- Federal Tax Credits for Consumer Energy Efficiency
- Production Tax Credits for Wind and Solar
- Marginal Well and Enhanced Oil Recovery Credit
- Cellulosic Ethanol Tax Credits

3.1.8. Conclusion

Developing new energy technologies is a worthy goal, but Washington's long-time policy of handouts and tax carve outs simply isn't working. Instead of producing energy solutions that can make it in the market place, we're left with failed green energy boondoggles (e.g., Solyndra, Beacon Power, Ener1 and A123 Systems). We're not any closer to our energy goals.

Furthermore, extending targeted tax provisions to companies is a tacit admission that the cost of conducting business in the U.S. is too high. It also admits that allowing companies to hold on to more of their money is good for economic growth. Unfortunately, politicians aren't tackling the bigger problem. Cutting the corporate tax rate would give American companies an incentive to invest here at home growing the economy and creating jobs. This would benefit American consumers, workers and employers. There are numerous studies that show targeted tax credits are ineffective at spurring economic growth.[58] However, general tax rate reduction is effective at accomplishing this goal.

Congress should eliminate all targeted loopholes in the tax code, including those for fossil fuels, nuclear energy and renewables. The United States can't have a truly level playing field unless Washington gets rid of all special exemptions for all energies.

3.2. Proper Tax Treatment of Domestic Energy Producers

In addition to the distortionary energy tax provisions listed above, there are numerous provisions that affect energy production that are

[58] Joint Economic Committee, *The Inefficiency of Targeted Tax Policies*, Apr. 2009.

currently the correct treatment but that have been discussed for reform. Chief among these provisions are dual capacity rules, intangible drilling cost expensing and section 199 manufacturing deduction.[59] There are also two traditional fuel production subsidies that should be repealed: the marginal well credit and the enhanced oil recovery credit.

3.2.1. Dual Capacity

Dual capacity taxpayers, those that operate multinational corporations and are subject to tax in both foreign and domestic jurisdictions, are able to claim a credit on their U.S. tax returns for levies paid to a foreign country.[60] This credit is necessary in order to avoid double taxation because the United States still, absurdly, taxes the worldwide operation of its companies.[61] Dual capacity taxpayers are only able to claim a domestic credit for tax levies, not royalties that generate a "specific economic benefit" even though such charges are a substantial cost of doing business for oil and gas producers.[62] Thus the dual capacity rule is not a special provision that exists to subsidize oil and gas companies. If anything, this section is underinclusive because expenses that could plausibly be claimed as a cost of doing business in a foreign jurisdiction do not generate the credit.

The Obama administration has, on multiple occasions, proposed changing the reporting and verification rules for dual capacity taxpayers. According to the Joint Committee on Taxation, the Administration's FY2013 "proposal would create a nonrebuttable presumption that a tax paid by a dual-capacity taxpayer to a foreign government is for a specific economic benefit" and thus not eligible for a credit under section 901(f).[63]

This proposal is misguided. Failing to allow U.S. multinationals to claim a credit for their foreign taxes will result in unnecessary and harmful double taxation. This double taxation will not be without economically damaging consequences. "By taxing foreign income twice, the proposal will negatively impact the foreign presence of U.S. companies which in turn will negatively impact U.S. jobs that support, directly or indirectly, the foreign operations of these multinationals," note Pinar Wilber and Margo Thorning writing for the American Council for Capital Formation.[64]

As with many tax provisions, section 901 only exists to correct another flaw in the code. If the United States taxed on a territorial – as opposed to worldwide – basis, U.S. multinationals would not owe U.S. taxes on their foreign operations' income. Therefore they would not need the foreign tax credits (FTCs) that section 901 provides.[65] Switching to a territorial system would resolve many of the United States' international competitiveness challenges.[66] It would also allow for simplification on the domestic side of the code.

3.2.2. Intangible Drilling Costs

As a general rule, section 162 provides that businesses may immediately expense "all the ordinary and necessary expenses paid or

[59] *See infra*, Part 6.1.
[60] 26 U.S.C. § 901.
[61] Pinar Cebi Wilber and Margo Thorning, *Why Do U.S. Dual Capacity Rules Matter?,* American Council for Capital Formation, Nov. 2012, available online: http://accf.org/wp-content/uploads/2012/11/ACCF-Special-Report-on-Dual-Capacity-Tax-FINAL.pdf.
[62] 26 U.S.C. § 901(f).
[63] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal*, June 2012, at 407.
[64] Wilber and Thorning, *supra* note 61, at 2.
[65] Entin, *supra* note 1, at 16, "There would be no foreign income and foreign tax credit offset to compute. … Tax treaties would relate only to the accurate allocation of costs between parts of a multinational business."
[66] *See infra*, Part 5.1

incurred during the taxable year in carrying on any trade or business."[67] Conversely, sections 167 and 168 provide for depreciation schedules and future deductions for capital investments that are "used in a trade or business" but are "held for the production of income" beyond the taxable year in which they are put into service.[68] As discussed elsewhere, AFP believes that this is not the correct treatment of capital expenditures.[69]

As it relates to oil, gas and geothermal-related taxpayers, section 57 provides an election for these taxpayers to either expense or capitalize their investments in production wells.[70] If Congress were to resolve the incorrect treatment of capital investments, this provision would be unnecessary. However, as the code reads today this provision is a small step in the right direction for the proper treatment of capital. As Heritage Foundation's Nicolas Loris and Curtis Dubay wrote:

> *"Immediate expensing allows companies to deduct the cost of capital purchases at the time they occur rather than deducting that cost over many years based on cumbersome depreciation schedules. Expensing is the proper treatment of capital expenditures. Depreciation raises the cost of capital and discourages companies from hiring new workers and increasing wages for existing employees. Immediate expensing for all new plant and equipment costs—for any industry or type of equipment—would allow newer equipment to come online faster, which would improve energy efficiency and overall economic efficiency."*[71]

AFP urges Congress to resolve the current incorrect treatment of capital investments. In lieu of that resolution, Congress should not exacerbate the problem by extending the incorrect treatment into new areas – areas that have traditionally been treated correctly, including intangible drilling costs.

3.2.3. Marginal Well Credit

In 2004, Congress enacted section 45I, establishing a credit for producing oil and gas from marginally productive wells.[72] The credit fluctuates in value based on the market-reference price. The phase in/out range for qualified crude oil is between $15 and $18 per barrel, and for natural gas between $1.67 and $2.00 per thousand cubic feet.[73] A marginal well is defined as those that on a daily basis produce "not more than 25 barrel-of-oil equivalents … and produces water at a rate of not less than 95 percent of total effluent."[74] The rationale for this credit is to smooth producer expectations when the price of energy declines.

According to the Independent Petroleum Association of America, "Eighty-five percent of all American oil wells are marginal wells, but they provide 20 percent of American oil production. Seventy-four percent of all American natural gas wells are marginal wells, providing 12 percent of American natural gas

[67] 26 U.S.C. § 162(a).
[68] 26 U.S.C. § 167(a).
[69] *See supra*, Part 2.1
[70] 26 U.S.C. § 57(a)(2).
[71] Nicolas Loris and Curtis Dubay, *What's an Oil Subsidy*, Heritage Foundation, May 12, 2011, WebMemo No. 3251, available online: http://www.heritage.org/research/reports/2011/05/whats-an-oil-subsidy.
[72] 26 U.S.C. § 45I.
[73] Independent Petroleum Association of America, *Marginal Well Tax Credit*, Apr. 2009, available online: http://www.api.org/~/media/Files/Policy/Taxes/2009-04-MarginalWellTaxCreditFactSheet.pdf.
[74] 26 U.S.C. § 45I(c)(3)(A).

production. … Removal of this important safety net for American production should be opposed."[75]

AFP believes that this argument is misplaced and that the Marginal Well Credit should be repealed. The tax code should not be used to subsidize production when the economics of the market do not warrant a good being produced. If the price of oil or natural gas dips below the level at which it is profitable for oil and gas companies to produce from marginal wells, then those wells should not be in service. As Heritage Foundation's Nicolas Loris and Curtis Dubay wrote, the Marginal Well Credit is among those subsidies that are "obvious and unnecessary" and a "preferential tax credit that Congress should repeal."[76] In a tax reform package that looks to remove targeted subsidies and lower overall rates, the Marginal Well Credit should be considered for repeal.

3.2.4. Enhanced Oil Recovery Credit

Section 43 provides for an Enhanced Oil Recovery (EOR) Credit equal to 15 percent of a taxpayer's enhanced oil recovery costs in a taxable year.[77] Like the Marginal Well Credit, the EOR credit phases out as the price of the market-reference price rises.[78] However, the EOR phase out point is much higher and is indexed to inflation. The IRS counsels that "Because the reference price for the 2009 calendar year ($56.39) exceeds $28 multiplied by the inflation adjustment factor for the 2009 calendar year ($42.57) by $13.82, the enhanced oil recovery credit for qualified costs paid or incurred in 2010 is phased out completely."[79]

The EOR credit is an industry-specific production subsidy and as such should be repealed. Oil and gas producers should not receive special treatment when it comes to the recovery of their costs that is based on the market price of a good. If they cannot profitably recover natural resources at a given price point, then they should not be subsidized by government to do so. Turning to the tax code for special deductions unduly distorts the economics of energy exploration. AFP urges Congress to remove this provision from the code.

3.3. Carbon Taxes

A federal carbon dioxide (CO2) emissions tax is often suggested by politicians, environmentalists and economists who seek to raise government revenues, reduce carbon presence in the atmosphere or address emission externality costs. As recently as February 2013, Senators Bernie Sanders and Barbara Boxer introduced a bill that would tax emitters $20 for every ton of carbon dioxide released over a certain limit, generate $1.2 trillion of revenue over ten years and attempt to reduce greenhouse gas (GHG) emissions to 80% below 2005 levels.[80] However, this Sanders-Boxer bill and other carbon tax proposals like it are fundamentally flawed. Carbon tax schemes are predicated on the assumptions that CO2 should be treated like other emissions, that taxing emissions can affect climate and that the net benefits of taxing GHG emissions outweigh the costs im-

[75] Independent Petroleum Association of America, *supra* note 73.
[76] Loris & Dubay, *supra* note 71.
[77] 26 U.S.C. § 43(a).
[78] 26 U.S.C. § 43(b).
[79] Internal Revenue Service, 2010-46 I.R.B., Nov. 15, 2010, available online: http://www.irs.gov/irb/2010-46_IRB/ar14.html.
[80] Valerie Volcovici, *Senators propose long-shot carbon tax bill for big polluters*, Reuters, Feb. 14, 2013, available online: http://www.reuters.com/article/2013/02/14/us-usa-climate-legislation-idUSBRE91D1BX20130214.

posed on businesses and consumers. These basic assumptions are incorrect and pursuing the overall objectives creates major economic distortions. AFP opposes carbon taxes because they impede economic growth and add tremendous costs to consumers and business while failing to affect the issue they purport to address.

3.3.1. Carbon Taxes are bad for the economy

All economic activity requires energy. From manufacturing processes, to commercial transportation, to utilities in an office building, energy makes every productive action possible. According to the Energy Information Agency, 83% of American energy came from fossil fuels in 2011.[81] Even in areas of the country where wind farms or solar panels provide some of the energy, fossil fuels are used to power homes and businesses when the wind is not blowing and the sun is not shining.[82] The United States is, and will remain for the foreseeable future, a fossil fuel-based economy. This leads to the inexorable conclusion that economic growth is tightly tied to carbon emissions. Citing this link between CO2 and economic growth, Tim Garrett, associate professor at the University of Utah's Department of Atmospheric Sciences, concluded that "we cannot become more prosperous and reduce our carbon dioxide emissions too."[83] Since a basic tenant on taxation is "that which you tax you destroy," it is clear that a tax on carbon emissions would be a direct impediment to growth and development in the United States.

It is easy to see how a tax on carbon emissions will damage the economy, but a closer look at the data reveals more alarming details. A recent study released by the National Associations of Manufacturers (NAM) examines the negative impact that a carbon tax would have on investment, production, consumption, employment and even federal revenue. Using a $20/ton of carbon tax as a model, NAM predicts such a policy would cut an average of $133 billion out of U.S. GDP each year over a 40-year period. This lost growth stems from higher energy costs, which result in decreased production. Within the first year of the tax, gasoline prices would increase 5.98%, natural gas prices would increase 43.6%, and coal prices would increase 110%. As result of higher production costs, the agriculture, commercial services, transportation services and manufacturing industries would all experience immediate and sustained reductions in output. The energy sector would be the hardest hit, losing 16% of coal production in the first year alone.[84]

As firms experience increasing costs of production, they cut back on production. When firms decrease their output, prices rise and employment falls. Under a carbon tax, the price of all goods and services would rise. The price of home utilities, perhaps the most substantial variable cost to American households, would increase significantly. The NAM study projects an 11.6% rise in residential electricity prices. In the face of rising prices, households will experience reduced purchasing power and will consume less. Sluggish business activity will also account for a 1% decrease in labor income and 1.5 million layoffs within the first year of implementation,

[81] U.S. Energy Information Administration, *Energy Perspectives 1949-2011*, Sept. 27, 2012, available online: http://www.eia.gov/totalenergy/data/annual/perspectives.cfm.

[82] Robert Wilson, *Why Renewables Need Gas*, The Breakthrough, Dec. 13, 2012, available online: http://thebreakthrough.org/index.php/programs/energy-and-climate/our-hybrid-energy-future/; *see also*, Ralph Vartabedian, *Rise in renewable energy will require more use of fossil fuels*, Los Angeles Times, Dec. 9, 2012, available online: http://articles.latimes.com/2012/dec/09/local/la-me-unreliable-power-20121210.

[83] Tim Garrett, *The physics of long-run global economic growth*, University of Utah Aerosol-Cloud-Climate Systems Group, available online: http://www.inscc.utah.edu/~tgarrett/Economics/Economics.html.

[84] National Association of Manufacturers, *Economic Outcomes of a U.S. Carbon Tax*, available online: http://www.nam.org/~/media/ECF11DF347094E0DA8AF7BD9A696ABDB.ashx.

according to the NAM study. These unfortunate outcomes mean that consumers, not just businesses, will bear a heavy burden from this tax. Like a vicious cycle, decreased production from a carbon tax weakens consumption and employment, which in turn will lead to further cuts in production. The government will also collect less revenue from taxes on capital and labor because of this decreased productivity. These losses have the potential to largely offset any revenue gains from the carbon tax.[85]

Looking at a real world example of a carbon tax offers more insight into the possible economic consequences. In July 2012, Australia implemented a $23AUD per ton tax on carbon emissions. Since then, electricity rates have increased – 10% for household and up to 30% for businesses. Thanks in part to these increased business costs as a direct result of the carbon tax, 10,632 Australian businesses closed in 2012.[86]

In America's current business climate, many businesses, particularly high energy use manufacturers, are likely to offshore their operations to a country with no carbon regulation in the face of a carbon tax. If domestic business managers and executives see their costs rise so dramatically that they must shut down, as so many did in Australia, offshoring will become an attractive alternative to salvage some of their profitability. A carbon tax creates incentives for businesses to leave the country and layoff American workers. This leakage effect will substantially limit the carbon-restriction capabilities of a carbon tax regime because companies will merely shift their carbon-emitting operations out of U.S. taxing jurisdiction. In such cases, the tax will only drive GDP investment, taxable business activity and jobs out of the country.

3.3.2. Carbon taxes are regressive and function like a VAT not a consumption tax

Carbon dioxide emission taxes are inherently regressive. As mentioned above, people rely on energy for all activities they engage in. The cost of energy is embedded in every good and service that businesses create and consumers purchase. A tax that increases the price of energy does not merely affect the energy-intensive industrial sectors; it also affects literally every business and household. When business face higher costs they will always pass those costs on to consumers with higher prices. These higher prices will be most harmful to lower-income people. A carbon tax would raise costs at every stage of production, not just to the final product, meaning that costs for every firm in a supply chain increase. Every business along the chain, from raw material extractors to retailers, will produce less and charge a higher price to their customers. As the price increases as products move down the supply chain, the last link on the chain, the final consumer, bears the brunt of all the added costs from every business up the chain. While consumers of every socio-economic status will experience this price hike, the high prices will disproportionately harm low-income people because they have the least amount of disposable income. Low-income individuals must designate proportionately larger amounts of their monthly incomes to necessities like food,

[85] *supra* note 84.
[86] Michael Bastrach, *Report: Australian carbon tax contributes to record number of businesses insolvencies*, The Daily Caller, Mar. 3, 2013, available online: http://dailycaller.com/2013/03/19/report-australian-carbon-tax-contributes-to-record-number-of-businesses-insolvencies/

residential utilities and travel. As the NAM study indicated, $20/ton carbon tax would add direct costs to those industries, putting an extra strain on poorer Americans' monthly budget.

Consumptions taxes, a taxation system that AFP supports but is also considered regressive, is quite different from a carbon tax in that they are transparent and if properly designed apply only to the final transaction in a supply chain. When a sales tax is added to a good or service, consumers know exactly how much extra they will have to pay. There is a given rate that applies to the cost of the goods and services consumers want to purchase and they know how much they pay to government. Carbon taxes are not transparent because consumers would not know what percentage the price of the goods and services they purchase comes from that tax. In a carbon tax system, consumers would not know how much of their money is going to government. Sales taxes apply only to the final sale after items have gone through all of the necessary production phases. This taxation method is less burdensome to consumers because the final amount paid is cheaper than what would be paid with carbon taxes. As explained before, a carbon tax imposes additional costs to every firm that modifies the final product along the supply chain. The government essentially taxes every value-added process for every domestically produced good. Carbon taxes engorge the final price and consumers can afford less as a result.

Beyond pricing, another regressive feature of carbon taxes is that many of the jobs they would destroy (both from discouraging production and encouraging outsourcing) would be low-wage, low-skill jobs. Low-income earners would not only lose a larger percentage of their income to rising costs of necessities, but in many cases they would actually lose jobs as well. A carbon tax would be very damaging to the lower end of the socio-economic scale.

3.3.3. Carbon taxes have minimal environmental benefit

Carbon tax proposals have been suggested as a way to combat global warming. Assuming for a moment that is a goal worth pursuing, a domestic carbon tax would do little to accomplish that goal. Carbon and GHG emissions are globally mixed. The emissions from a particular spot in the world are not localized to that area, but will contribute to atmospheric levels over the whole world. In other words, GHG levels in the atmosphere are collectively influenced by all emissions. The emissions from every other country around the world are just as relevant to the atmospheric conditions for the United States as emissions coming directly from the U.S. There is no "national" GHG level, only a global aggregate. Curbing emissions from the United States would result in only negligible reductions in global aggregate carbon dioxide levels but come at an enormous cost to the U.S. economy.

Once emitted from any location on the planet GHG emissions spread throughout the entire atmosphere, so every single property owner in the world could claim to be harmed by every single emitter (if you assume the property owners own the shifting atmosphere above their property). There is no way to record how much each emitter contributes to the total CO2 release. Every business contributes to emissions through economic activity and every individual person, no matter how environmentally conscience, emits carbon in their daily activities. Even if damages could be accurately determined, the only way to fully internalize the costs would be to tax the emissions from literally every emitting party in the world. This is obviously not feasible.

3.3.4. Conclusion

A tax on carbon is a clumsy and destructive approach to curbing emissions. Increased CO2 emissions are a direct result of economic growth. Taxing emissions would add prohibitive costs on businesses and consumers, causing reduced production, higher prices, offshoring and layoffs. This plan would severely cut into GDP growth while contributing less than projected to net government revenue (accounting for lost revenues from decreased taxable business activity). Offshored U.S. businesses, not to mention existing foreign businesses, will continue producing and relying on fossil fuel energy but cease contributing to U.S. employment and economic growth. Taking both economics and the environment into consideration, the marginal costs of a carbon tax far exceed the benefits. For the aforementioned reasons, AFP is opposed to a carbon tax.

4. Income & Tax Distribution

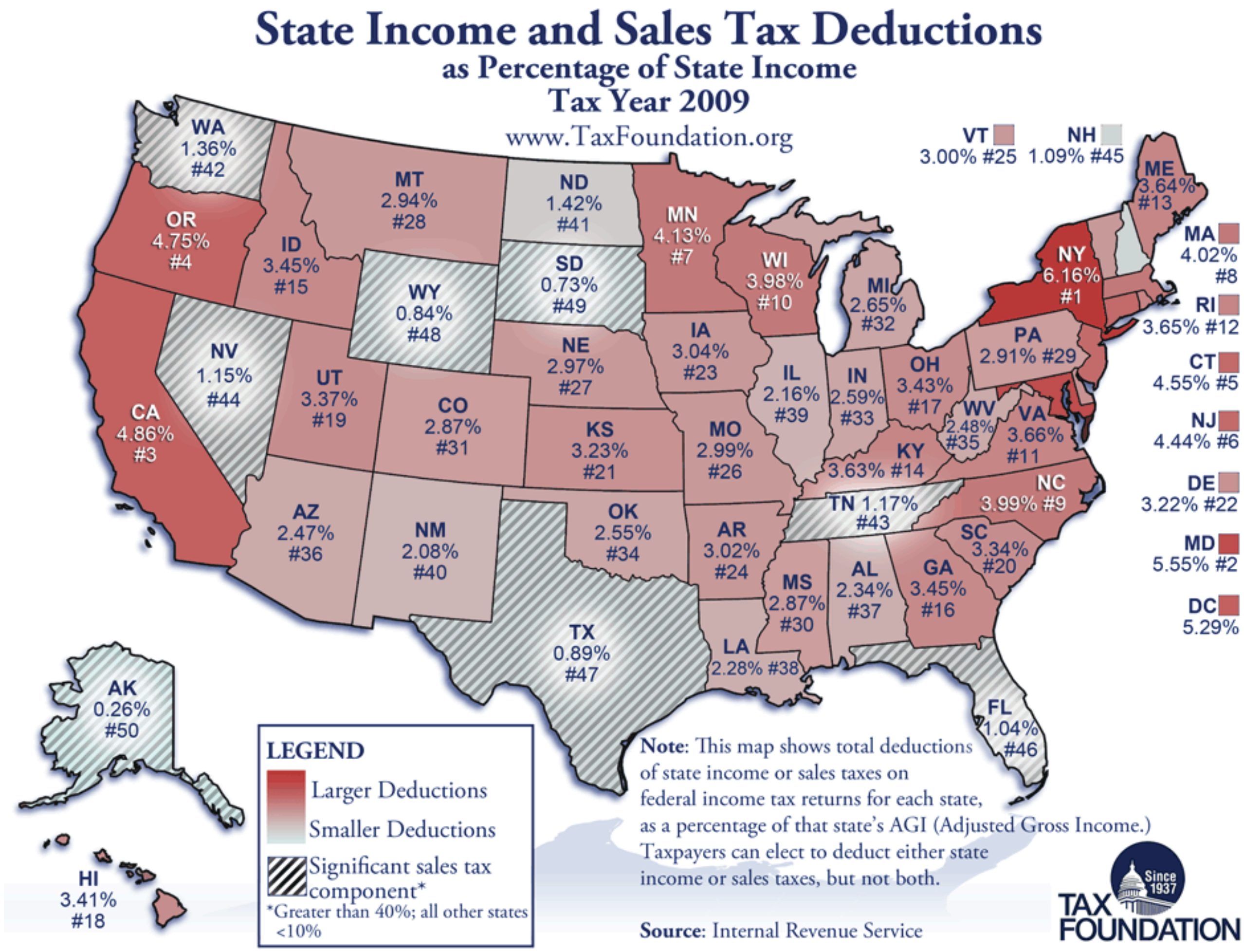
4.1. State and Local Provisions: Tax Deductions and Bond Interest

Since the inception of the income tax in 1913, the federal government has carved out a number of provisions in the code to benefit state and local governments. Today, filers can deduct state and local income and property taxes from their taxable liability.[87] Taxpayers also have the option to deduct sales taxes in lieu of income taxes.[88] Furthermore, interest income from state and local bond investments is excluded from taxable income.[89] Although they certainly lower filers' tax liability, state and local deductions do so in an economically destructive manner by encouraging state and local governments to levy high taxes and spend at a fiscally unsafe rate. Thus, sections 103 and 164 of the tax code should be eliminated completely.

4.1.1. State and Local Tax Deductions Subsidize Big Government

The origins of state and local tax deductions trace back to the inception of the federal income tax in 1913, with the Revenue Act of that year providing for the deduction of "all national, State, county, school, and municipal taxes."[90] Since no state levied a sales tax at the time of passage, the law applied most prominently to state and local income and property taxes. However, after Mississippi introduced the first state sales tax, the federal tax code quickly followed suit with a 1942 revision explicitly allowing for the deduction of sales tax. Four decades later, the sales tax deduction was repealed in the Tax Reform Act of 1986 in an attempt to broaden the tax base, only to be temporarily reinstated in 2004 as an optional deduction in lieu of the income tax deduction. This optional sales tax deduction still survives today, having being temporarily extended biannually since 2006. Currently, all three deductions are located in section 164 of the federal tax code.[91]

[87] 26 U.S.C. § 164.
[88] 26 U.S.C. § 164(b)(5)(A).
[89] 26 U.S.C. § 103.
[90] Steven Maguire, *Federal Deductibility of State and Local Taxes*, Congressional Research Service, Sept. 20, 2012, available online: http://www.fas.org/sgp/crs/misc/RL32781.pdf.
[91] 26 U.S.C. § 164.



These deductions effectively subsidize state and local governments by reducing filers' federal tax base, freeing up income for state and local governments to collect in revenue. Such a perk also quells opposition to state and local tax increases because a filer experiences the local tax hike as an offsetting reduction in their federal tax liability. As economist Dan Mitchell explains, "[A] taxpayer in the 35 percent federal tax bracket suffers only a 65-cent drop in after-tax income when state and local taxes rise by \$1."[92] Consequently, this section of the federal code perversely incentivizes government growth since it increases as state and local regimes raise taxes.

This effect is greater in states with higher income taxes, such as California, Maryland and New York. What's more, because the state and local tax deductions are only available to taxpayers who itemize deductions on their returns, they are disproportionately claimed by upper-income taxpayers in high-tax states. Eliminating this subsidy would require high-

[92] Daniel J. Mitchell, *The Deduction for State and Local Taxes Undermines Tax Reform and Subsidizes High-Tax States*, Heritage Foundation, July 25, 2005, available online: http://www.heritage.org/research/reports/2005/07/the-deduction-for-state-and-local-taxes-undermines-tax-reform-and-subsidizes-high-tax-states.

tax states to stand on their own two feet, funding their big government budgets with their own revenue and without help from taxpayers in other states. Mitchell estimates that "[a]s many as 40 states would be net winners if the state and local tax deduction were repealed and the money used to lower tax rates."[93]

Indeed, there is a scholarly consensus that repealing state and local tax deductions would consequently lower taxes and spending in the states. For example, Douglas Holtz-Eakin and Harvey Rosen estimate that "if deductibility were eliminated, the mean property tax rate in our sample would fall by 0.00715 ($7.15 per $1,000 of assessed value), or 21.1% of the mean tax rate."[94] Additionally, the Congressional Research Service acknowledges that "state and local public spending would decline" if tax deductions were eliminated. Such decreases in taxation and spending would increase economic growth, as seen by decades of government data.

Since 1948, the nonpartisan Tax Foundation has ranked states' tax climates based on how low, flat and simple their rates are.[95] The stark contrast in economic growth between low- and high-tax states seen in data from the Bureau of Economic Analysis and Census Bureau tells a compelling tale about the destruction burdensome tax climates can wreak on economic growth. The ten states with the best tax climates experienced 35.9% faster personal income growth, 57.6% faster gross domestic product growth and 142% faster population growth from 2001 to 2011 than the worst ten states.[96] Removing federal deductions for state and local income, property and sales taxes would reduce states' incentives to levy harmfully high tax rates and thereby increase economic growth.

Some pundits will propose making the temporary sales tax deduction permanent instead. After all, sales taxes are the least economically destructive tax since their marginal rates don't distort saving and investment decisions as income taxes do. Nevertheless, they still subsidize state and local governments and encourage higher taxes and spending as a result. Thus, the optimal choice would be to repeal state and local tax deductions completely, regardless of the relative merits of each tax. Closing state and local income deductions across the board would increase federal revenue by an estimated $61.1 billion in 2013, which can be put to lowering rates across the country, fueling America's engine of prosperity.[97]

4.1.2. State and Municipal Bond Exclusions Encourage Unsustainable Spending

As if state and local tax deductions weren't harmful enough, state and local bond interest income exclusions have similar negative economic effects. Section 103 of the tax code excludes state and local bond interest income from a filer's gross income.[98] As a result, taxpayers are encouraged to invest in bonds since the returns are not taxed. This increased demand has the effect of driving down state and local borrowing costs as interest rates drop. Consequently, state and local governments are encouraged to issue more debt, more cheaply than they otherwise would. When the fed-

[93] Mitchell, *supra* note 92.
[94] Douglas Holtz-Eakin and Harvey Rosen, *Federal deductibility and local property tax rates*, 27 J. of Urban Econ. 269 (1990).
[95] Scott Drenkard and Joseph Henchman, *2013 State Business Tax Climate Index*, Tax Foundation, Oct. 9, 2012, available online: http://taxfoundation.org/article/2013-state-business-tax-climate-index.
[96] Casey Given, *Tax Reform Sweeps the States*, Americans for Prosperity, Feb. 12, 2013, available online: http://americansforprosperity.org/legislativealerts/tax-reform-sweeps-the-states/.
[97] Maguire, *Federal Deductibility of State and Local Taxes*, *supra* note 90.
[98] 26 USC § 103.

eral income tax was first introduced in 1913, it allowed filers to exclude state and local bond interest under the assumption that taxing these profits was unconstitutional under the Tenth Amendment and the doctrine of intergovernmental tax immunity.[99] However, in 1988 the Supreme Court held in South Carolina v. Baker that the federal government could indeed tax state bond interest.[100] Congress was not yet availed itself of this opportunity.

Unfortunately, this well-intended policy has turned into a nightmare, as state and local governments have piled up mountains of debt that threaten to bury the economy. According to the most recent data, state and local governments owe more than $2.8 trillion in debt and pay an unbelievable $199 billion each year just to service the interest on their bonds.[101] In addition to explicit debt, state and local governments also owe $2.8 trillion in unfunded public pension liabilities and $627.2 billion in retiree health benefits.[102] Eliminating the state and local bond interest exclusion would eliminate one of the major causes of our country's debt crisis.

Of course bonds are an absolutely necessary financial tool for governments to build facilities needed to carry out their essential functions like maintaining roads and sewers. However, they have gone too far, especially since government bonds these days are often rife with cronyism. In city after city and state after state, crony governments are funneling bond money to private businesses. Kansas' Sales Tax Anticipation Revenue bonds, for example, siphoned millions of dollars in bonds to developers for projects like the Kansas Speedway and Heartland Park Racetrack.[103] Eliminating the bond interest exclusion will end the easy money that political cronies have wasted for decades, leveling the playing field for more principled businesses to compete in the marketplace.

Although President Obama and congressional leaders have agreed on economically destructive tax reforms like capping itemized deductions instead of eliminating them for simplicity, ending the bond interest exclusion is one bipartisan proposal with real fiscal and economic merit. In 2011, the federal government saw $26.2 billion in lower revenue because of the exclusion.[104] Ending this exclusion would generate revenue that would be put to better use lowering tax rates and easing the burden of debt governments have placed on taxpayers' shoulders. In order to ensure an orderly transition and not unduly disrupt the bond market and current bondholders' investments, AFP urges Congress to establish a prospective date beyond which interest income gained from future state and local bond offerings would not be excluded from taxable income.

4.2. Limiting Itemized Deductions

One tax reform that has gained political traction since the 2012 presidential election is limiting itemized deductions while still keeping most of the deductions in the code. During the race to the White House, both major candidates campaigned for increasing tax revenue by limiting filers' access to deductions. President Obama proposed reducing the rate at which earners of $200,000 and above could claim itemized deduc-

[99] Steven Maguire, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, Congressional Research Service, June 19, 2012, available online: http://www.nabl.org/uploads/cms/documents/2012-13313-1.pdf.

[100] *South Carolina v. Baker*, 485 U.S. 505 (1988).

[101] U.S. Department of Commerce, Census Bureau, *State and Local Government Finances by Level of Government and by State: 2009-10*, (2012).

[102] State Budget Solutions, *State Debt Profiles 2012*, (2012).

[103] Peter Schweizer, *A Trillion Dollar Tax Increase that Republicans and Obama Should Agree To*, Forbes, Dec. 12, 2012, available online: http://www.forbes.com/sites/realspin/2012/12/13/a-trillion-dollar-tax-increase-that-republicans-and-obama-should-agree-to/.

[104] Maguire, *Tax-Exempt Bonds*, *supra* note 99, at 4.

tions to 28%.[105] Governor Mitt Romney proposed capping itemized deductions to a specific dollar amount, often quoted as $17,000. As a result of this seeming-bipartisan consensus for limiting access to itemizing deductions, the Taxpayer Relief Act of 2012 reinstated the Pease limitation of the 1990s, reducing most itemized deductions by 3% for income earners of $250,000 and more.[106]

Limiting itemized deductions is popular among elected officials on both sides of the aisle because it increases revenue while avoiding the messy business of identifying specific provisions to eliminate. However, popularity is not necessarily an indicator of sound fiscal policy. Limiting itemized deductions would do nothing to simplify the overly complex tax code.

The tax code's complexity is a tax in and of itself. Taxpayers spend more than 4.3 billion hours and $159.6 billion to file their returns each year.[107] This incredible loss of labor and money could be put to better use in the private sector building long-term economic growth. Thus, tax codes should be designed as simply as possible. While champions of limiting deductions like to claim that such a policy would simplify the tax code, it does nothing of the sort. To the contrary, it only adds another layer of complexity by requiring filers to calculate their deduction cap after calculating their deductions. Filers would then structure their economic decision making by picking which deductions they want to stay under the cap.

Reforming the tax base, in a neutral way, is a perfectly legitimate policy option as a means of generating revenue sufficient to lower tax rates. However, this aim should not be achieved by adding more rules to the overly bureaucratic tax code. Rather, it should be achieved by eliminating unnecessary provisions. Undoubtedly, this is a tougher task than slapping on a simple cap because Congress would have to tackle the tax code line by line. It's time to do the hard work of eliminating provisions, not just using caps to avoid hard choices.

4.3. Simplifying Brackets

The federal government collects income taxes according to a progressive marginal rate structure. The more an individual makes in yearly income, the greater percentage of income the government takes out of their earnings.[108] Until the beginning of 2013, the code had six different brackets for personal income taxes. After Congress passed the American Taxpayer Relief Act of 2012, a seventh tax bracket was added on top of the other six. According to the Tax Foundation, for single filers the new tax brackets occur from $0-$8,925 at a 10% rate, $8,925-$36,250 at a 15% rate, $36,250 to $87,850 at a 25% rate, $87,850-$183,250 at a 28% rate, $183,250 to $398,350 at a 33% rate, $398,350 to $400,000 at a 35% rate and over $400,000 at a 39.6% rate.[109] Thus, as individuals earn more income annually, the government not only takes more of their earnings on an absolute scale, but also on a relative scale, through the system of progressive marginal income taxation.

AFP believes that the tax code should not be used to demonstrate preference to individuals on the basis of their income status. The tax code should be as flat, low, simple and neutral as possible. According to these tax principles the

[105] James B. Stewart, *Tax Plan Is Popular, but Not Quite Fair*, The New York Times, Dec. 14, 2012, available online: http://www.nytimes.com/2012/12/15/business/plan-to-cap-deductions-is-setback-for-charities.html?pagewanted=all.
[106] American Taxpayer Relief Act of 2012, Pub. L. No. 112–240, 126 Stat. 2313 (2013).
[107] Nicole V. Crain and W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, U.S. Small Business Administration, Sept. 2010, available online: http://www.sba.gov/sites/default/files/The%20Impact%20of%20Regulatory%20Costs%20on%20Small%20Firms%20(Full).pdf.
[108] 26 U.S.C. § 1.
[109] Tax Foundation, *2013 Tax Brackets*, Jan. 3, 2013, available online: http://taxfoundation.org/blog/2013-tax-brackets.

current model of progressive taxation, rife with complicated deductions and credits, fails the most basic test. Not only is it premised upon the flawed idea that as individuals earn more income they not only pay more taxes but higher percentage of taxes, but it also contains a highly complex system that few individuals have the time or resources to properly follow.

One reason many individuals defend progressive taxation is because they believe it will reduce income inequality. In fact, much has been made recently about income inequality in America, and President Obama made it a primary talking point in his campaign for reelection. Kip Hagopian points out that two significant reasons for supporting a progressive income tax are either based on a theory of fairness—which can include the desire to make the wealthy pay more due to the nebulous concept of their "ability to pay" more—or a separate desire to generally reduce income inequality.[110]

Yet, these arguments fail to address the key moral conundrums that a progressive income tax system creates. Namely, if an individual becomes wealthy through hard work, honest means and financial aptitude, progressive taxation punishes her by taking a greater share of her income even though she rightfully and honestly earned all of it. In short, progressive taxation is bad policy from a moral perspective because it punishes value creation and hard work.

Furthermore, the arguments implicitly accept the notion that taxation is a burden for the poor, but then arbitrarily demands that the rich should bear more of that burden. Ironically, this ultimately has little to no benefit for those in poverty, but it certainly has a benefit for government, which collects the revenue, and for candidates who trumpet the message of alleviating inequality. It is convenient that the ideological support for progressive taxation message tests well for candidates seeking office, an observation that led the economist, Ludwig von Mises, to observe, "Nothing is more calculated to make a demagogue popular than a constantly reiterated demand for heavy taxes on the rich. Capital levies and high income taxes on the larger incomes are extraordinarily popular with the masses, who do not have to pay them."[111]

Mises observation perfectly bridges the moral refutation of progressive taxation with the efficiency refutation of progressive taxation. After deductions and credits, the federal tax code effectively removes individuals in the lower brackets from the reality of the cost of the modern welfare state (even as government continues to provide benefits at taxpayer expense). According to CBO, 67.9% of all federal taxes in 2009 were paid by the highest quintile of Americans by income.[112] Meanwhile, the lowest quintile of Americans by income only paid 0.3% of all federal taxes. To put this in perspective, no other modern nation relies on the wealthy to pay such a vast share of taxes to the government as much as the United States does today.[113] Consequently, most Americans do not feel the burden of paying for the massive welfare state that they demand when they also seek higher tax brackets for the wealthy.

A flat and low tax system escapes the moral problems and economic inefficiencies that plague the progressive tax system. Because all individuals pay the same rate, there's less of an incentive to game individual tax brackets because everyone

[110] Kip Hagopian, *The Inequity of the Progressive Income Tax*, Hoover Institution at Stanford University, Apr. 1, 2011, available online: http://www.hoover.org/publications/policy-review/article/72291.

[111] Ludwig Von Mises, Socialism 494 (1962).

[112] Congressional Budget Office, *The Distribution of Household and Federal Taxes, 2008 and 2009*, Jul. 2012, available online: http://www.cbo.gov/sites/default/files/cbofiles/attachments/43373-06-11-HouseholdIncomeandFedTaxes.pdf.

[113] Scott A. Hodge, *No Country Leans on Upper-Income Households as Much as U.S.*, Tax Foundation, Mar. 2011, available online: http://taxfoundation.org/blog/no-country-leans-upper-income-households-much-us.

is under the same tax bracket. It also doesn't punish anyone for how poor or rich they are because everyone pays the same rate. Therefore, Giertz and Feldman point out that it is "more resistant to tinkering."[114]

In light of these issues, AFP urges Congress to both lower and flatten personal income tax rates. There are currently proposals in Congress to do just this. House Budget Committee Chairman Paul Ryan's budget would establish a two-rate system at 10% and 25% (with the final income brackets to be determined by Ways and Means).[115] In a similar fashion, the Republican Study Committee's budget also establishes a 15% and 25% rate.[116] Finally, Sen. Rand Paul's budget makes the boldest move of any of the proposed budgets by eliminating all current tax brackets and replacing them with one flat rate at 17%.[117] All of these proposals would move the United States away from its deeply progressive and complex tax system in order to replace it with a flatter tax system.

4.4. *Indexing Brackets to Wage Growth instead of Inflation*

This section was originally published as an independent post on Americans for Prosperity's website.

Chained CPI Shift Doesn't Have to Mean a Tax Hike[118]

Lost among the frenzy to raise taxes, the only substantive programmatic spending reduction that the two sides agree on is an adjustment to the way Social Security Cost of Living Adjustments (COLAs) are calculated. The current formula uses the Consumer Price Index for Urban Wage Earners (CPI-W); the two sides have agreed to switch to a variation of that metric called chained CPI. Transitioning all Social Security recipients to chained CPI would reduce future expenditures by roughly $217 billion over ten years. President Obama has proposed using chained CPI for only wealthier retirees, reducing the savings by about half. However, the proposed change would not only result in Social Security savings, it would also be a tax hike. But this doesn't have to be the case

CPI is a measure of inflation: increasing prices for consumer goods over time. However, it's a static measure. It doesn't take into account the basic economic fact that people's behavior changes according to the price signals they receive from the market. Chained CPI, in contrast, attempts to measure that effect. For example, if the price of a certain good increases because of inflation, some consumers will shift their purchases away from that now-more-expensive good to a more affordable alternative: a basic substitution effect. The effect of this shift is that it makes it easier for people to cope with higher prices. Using static CPI for the Social Security benefits thus provides a higher adjustment than the market really demands. Switching to chained CPI would resolve this issue. It would also result in a large reduction in projected future spending, which is why it's currently on the negotiating table.

The current proposals to adopt chained CPI would also affect how the marginal income tax brackets are adjusted every year to prevent what's known as "bracket creep." Bracket creep is a stealth tax increase because, like prices, wages also

[114] Seth H. Giertz and Jacob Feldman, *The Economic Costs of Tax Policy Uncertainty: Implications for Fundamental Tax Reform*, Mercatus Center at George Mason University, Nov. 27, 2012, available online: http://mercatus.org/sites/default/files/TaxUncertainty_Gietz_v1-0_1.pdf.

[115] U.S. House Budget Committee, *The Path to Prosperity: A Responsible, Balanced Budget*, Mar. 2013, available online: http://budget.house.gov/uploadedfiles/fy14budget.pdf.

[116] Republican Study Committee, *Back to Basics: A Budget for Fiscal Year 2014*, Mar. 2013, available online: http://rsc.scalise.house.gov/uploadedfiles/back_to_basics-rsc_fy2014_budget.pdf.

[117] Senator Rand Paul, *A Clear Vision to Revitalize America*, Mar. 2013, available online: http://www.paul.senate.gov/files/documents/FY2014Budget.pdf.

[118] James Valvo, *Chained CPI Shift Doesn't Have to Mean a Tax Hike*, Americans for Prosperity, Dec. 20, 2012, available online: http://americansforprosperity.org/legislativealerts/chained-cpi-shift-doesnt-have-to-mean-a-tax-hike/.

tend to rise over time. If the income threshold at which an individual moves from one tax bracket to the next is not routinely adjusted upward, taxpayers find themselves graduating into higher rates when their incomes relative to purchasing power haven't really changed. To prevent this bracket creep, the brackets are tied to CPI, just like the Social Security COLAs. The tax brackets use CPI-U, while Social Security uses CPI-W.

The current proposals to shift to chained CPI would cover both taxes and benefits. If chained CPI is used for the brackets, it will decrease the speed at which the thresholds are adjusted upward, resulting in a de facto tax increase as taxpayers will run into higher rates sooner than they otherwise would. But this doesn't need to the case.

Using chained CPI for Social Security benefits makes sense because you're trying to measure how far an individual's Social Security check will carry him or her in the market, how much can he or she purchase. That's a measure of the cost of goods and thus adjusting for inflation (or inflation taking account people's changing behaviors) is appropriate. However, marginal income tax brackets have nothing to do with the cost of goods; they are related to wage growth. Ignoring the difference between a taxpayer receiving money (income subject to marginal rates) and a taxpayer spending money (using Social Security benefits to buy goods) creates the false equivalency we see in the Obama and Boehner proposals.

A much better solution to solving the bracket creep problem is to tie the yearly bracket adjustments to some measure of wage growth. The Bureau of Labor Statistics already provides various metrics that could be adopted. One possible solution would be to use the Average Hourly Earnings (AHE) data that surveys payrolls but excludes benefits; this would be sensible for bracket adjustments because the largest non-wage employee benefits (employer-sponsored insurance, etc.) are excluded from taxable income. One drawback to the AHE measure is that it only includes production and nonsupervisory employees. Another option is the Compensation per Hour metric, which does include benefits but also covers all employees. Of course switching to a form of "CPI for wages"[119] begs the question: Shouldn't we use a chained metric in this area too in order to account for individuals shifting toward careers with rising wages? Perhaps, but labor mobility is lower than consumption elasticity, and therefore the shift would not be as large.

Switching to chained CPI for Social Security benefits would reduce future spending but make an already bad retirement deal even worse for beneficiaries. However, that's no reason to measure marginal bracket adjustments incorrectly. Adjusting benefits according to inflation and brackets according to wage growth makes much more sense.

5. International Taxation

5.1. Switching from a Worldwide to Territorial System

The United States' current corporate tax system—worldwide taxation with deferral—is flatly uncompetitive, punishing firms for investing and expanding internationally. This structure produces an inefficient, uncompetitive and compliance-heavy structure for U.S. firms. AFP urges Con-

[119] Joseph A. Ritter, *Opening Pandora's Box: The Measurement of Average Wages*, Federal Reserve Bank of St. Louis, Review March/April 1996, available online: http://research.stlouisfed.org/publications/review/96/03/9603jr.pdf.

gress to transition from this faulty system into a territorial tax system that taxes firms once, and only once, based on where income is earned.

Under the current corporate tax system, U.S. firms are taxed on active foreign income regardless of where the income is earned. However, firms may delay taxation until the income is repatriated to the U.S. through the deferral process. That deferral process is accomplished by delaying the distribution from a foreign subsidiary or department back to the domestic U.S. parent. For example, a U.S. firm earns $1 million through its Irish operations. The firm would pay $125,000 to Ireland based on the 12.5% Irish corporate income tax rate when the income is earned. It would pay an additional $225,000 (the difference between the 35% U.S. corporate income tax rate and the 12.5% Irish rate) to the United States when the funds are repatriated for a total tax of $350,000.

The United States' corporate tax rate is the highest among the 34 nations in the Organisation for Economic Cooperation and Development, putting the U.S. at a competitive disadvantage and discouraging investment from both domestic and foreign firms.[120] Additionally, 26 of the OECD countries operate under a territorial system or exempt 95% of foreign earnings from taxes. The seven other countries operating under a worldwide taxation system have much lower corporate tax rates; the U.S. is the only country with worldwide taxation and an operative corporate tax rate above 30%.[121]

This taxation structure represents a large barrier to firms moving assets back into the United States. Because of deferral, firms are able to choose when to trigger their domestic tax liability. This deferral provides a distinct incentive not to move assets. More than $1 trillion in cash is estimated to be sitting within foreign subsidiaries of U.S. firms preventing further domestic economic growth. This is cash that is not being used to further domestic investment, being returned to shareholders or used to expand the American labor force; money that is only sitting idle because of the U.S. tax code.

Study after study has shown that activity by firms is highly influenced by repatriation rates. In 2001, a study found that dividend repatriations are indeed affected by the tax rate paid on repatriation.[122] A 2007 study found that repatriation taxes are a large reason why firms hold large amounts of cash offshore.[123] Similar results were observed following the 2004 passage of the American Jobs Creation Act (AJCA). This act created a one-time reparation holiday—subject to a 5.25% tax. Over $300 billion in capital was returned to the United States during this holiday.[124] A survey of 400 tax executions found that over 60% of that capital came from international holdings. Repatriation tax holidays are an admission that our current international tax system is not working. Further, these holidays increase the incentive for corporations to hold assets offshore as they wait for the next holiday to reduce their tax liability. This leads to inefficient capital allocations and unnecessarily limits capital flows.

This system also increases compliance costs for U.S. firms as they grapple with the complex rules regarding repatriation. Compliance with the corporate tax code costs firms billions every year.

[120] Organisation for Economic Cooperation and Development, *Basic (non-targeted) corporate income tax rates*, (2012), available online: http://www.oecd.org/tax/tax-policy/oecdtaxdatabase.htm#C_CorporateCaptial.

[121] Scott A. Hodge, *Special Report: Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings*, Tax Foundation, No. 191, May 2011, http://heartland.org/sites/default/files/hodge_sr191.pdf.

[122] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., *Repatriation Taxes and Dividend Distortions*, National Bureau of Economic Research, Working Paper 8507, available online: http://www.nber.org/papers/w8507.pdf.

[123] C. Fritz Foley et al, *Why do Firms Hold so Much Cash? A Tax-Based Explanation*, National Bureau of Economic Research, Working Paper 12649, available online: http://www.nber.org/papers/w12649.pdf.

[124] John R. Graham, Michelle Hanlon and Terry Shevlin, *Barriers to Mobility: The Lockout Effect of US Taxation of Worldwide Corporate Profits*, http://cber.bus.utk.edu/confpapers/Gra_Han_She.pdf.

According to one study, 40% of those costs are related to the international tax provisions in the code, or 8.5% of all foreign-sourced income.[125]

Finally, this system encourages firms to expand their debt holdings to fund growth; this effect is in addition to the preferential tax treatment of debt versus equity financing.[126] According to John Graham, et al, "nearly 44 percent of companies" reported that they increased their outstanding debt in spite of large sums of liquid assets within their foreign-owned subsidiaries. Graham et al continue by saying "nearly 20 percent of the respondents noted that their company had invested the foreign earnings in financial assets with a lower rate of return than they could have earned in the U.S. All of this evidence is consistent with a significant lockout effect from the U.S. tax policy that taxes the worldwide income of U.S. multinationals."[127]

Numerous experts recognize the importance of moving from the punishing worldwide system with deferral into a territorial system. The President's Fiscal Commission, known commonly as the Bowles-Simpson Commission, proposed moving to a territorial system in 2010 to "put the U.S. system in line with other countries, leveling the playing field."[128] Similarly, both the President's Export Council and his Jobs Council also endorsed this important change in taxation.[129]

This change will harmonize the U.S. tax code with its international competitors and foster further economic growth and domestic development. Reducing compliance costs and allowing capital to move freely removes unnecessary burdens that reshape corporate decision-making. A territorial system allows firms to allocate resources to the best possible project; not the tax-advantaged or tax-punished project.

6. Manufacturing

6.1. Section 199

In 2004, Congress enacted section 199, which provides a deduction for "Income attributable to domestic production activities."[130] The value of this deduction was increased during a phase-in period until it reached its current permanent value at 9 percent of the lesser of qualified activities income or taxable income for the taxable year.[131] However, as it relates to domestic oil and gas production, the value of this deduction was frozen during the phase-in period. Oil and gas producers may claim a deduction that is "reduced by 3 percent" from the more broadly applicable 9 percent.[132]

Some critics, including Senator Robert Menendez (D-N.J.), claim that section 199 is a special tax subsidy for oil and gas providers and thus should be repealed with respect to those producers.[133] It is more accurate to say that section 199 is a special subsidy for all domestic manufactures, not simply for certain industries. The fact that Congress feels the need for section 199 is an admission that the United States' corporate tax rate is too high and thus our domestic manufacturers are at a disadvantage in the global economy.

Instead of singling out oil and gas producers for certain disfavored tax treatment under section 199, AFP encourages Congress to enact tax reform that removes the need for section 199 in

[125] Hodge, *Special Report, supra* note 121.
[126] See *supra*, Part 2.4.
[127] Graham, Hanlon & Shevlin, *supra* note 124.
[128] National Commission on Fiscal Responsibility and Reform, *supra* note 16.
[129] *Id.* at 47.
[130] 26 U.S.C. § 199.
[131] 26 U.S.C. § 199(a)(1).
[132] 26 U.S.C. § 199(d)(9)(A).
[133] Office of Senator Robert Menendez, *Menendez Reintroduces Bill to End Taxpayer-Funded Subsides for Big Oil Companies*, Feb. 13, 2013, available online: http://www.menendez.senate.gov/newsroom/press/menendez-reintroduces-bill-to-end-taxpayer-funded-subsides-for-big-oil-companies.

the first place. Placing all domestic manufacturers on a level playing field and lowering the top corporate tax rate will restore our competitiveness and remove the need for this provision.

6.2. Medical Device Tax

Section 9009 of PPACA, as amended by the Health Care and Education Reconciliation Act of 2010, imposes an excise tax on the sale of any medical device by a "manufacturer, producer, or importer" starting on January 1, 2013. This tax will have devastating effects on the medical device market and should be repealed.

This tax assesses a 2.3 percent tax on the sale of any domestic or foreign-made medical device sold in the United States. PPACA makes exceptions for "eyeglasses, contact lenses and hearing aids." All other medical devices sold in the United States are subject to this tax.

According to analysis by the American Action Forum, this tax will have dramatic effects on the United States economy.[134] This study estimates that between 14,000 and 47,000 jobs will be lost due to this tax; these are the direct job losses and do not include other macro-economic effects. These job losses are particularly fueled by the odd type of tax that is assessed. Instead of a traditional income tax, the Medical Device Tax is an excise tax on the sales price of the device sold. Firms with tight profit margins, small businesses or those losing money are hit the hardest.

Congress has already shown a willingness to repeal this misguided tax. During the 112th Congress, the House voted 270-146 to repeal the Medical Device tax.[135] Similarly, during the current 113th Congress, the Senate voted 79-20 to pass a non-binding resolution to repeal the tax.[136] Repeal is being led by numerous PPACA supporters including Senators Al Franken (D-Minn.), Amy Klobuchar (D-Minn.), Dick Durbin (D-Ill.) and Elizabeth Warren (D-Mass.).

7. Pensions & Retirement

7.1. Removing Contribution Caps on Retirement Accounts

The federal government has allowed for a number of tax-preferred savings accounts for individual employees. These accounts are designed to encourage employees to save money for retirement, educational expenses and health care by allowing individuals to exclude their contributions from their gross income. However, these accounts also come with annual caps that limit how much money individuals can contribute. Not only do these caps differ from account to account, but they also represent a direction violation of the financial freedom of individuals who would like to save more than the limitations allow.

The specific rules regarding some of these tax-preferred accounts can be found in sections 401(a), 401(k), 403(a) and (b), 408(k) and (p), 457(b), 529(a) and 530(a). Although some of these focus on educational savings accounts (such as those in sections 529 and 530), some of the most popular tax-preferred savings accounts are those that focus on retirement savings, such as those described in sections 401 and 408. Each of these accounts has their own contribution limitations. For example, individual retirement accounts (both traditional and Roth) in 2013 are limited to $5,500 in annual contributions ($6,500 if older than 50).[137] Additionally, 401(k) contribution limits are set at $17,500 in 2013.[138] Mean-

[134] Michael Ramlet, Robert Book and Han Zhong, *The Economic Impact of the Medical Device Excise Tax*, American Action Forum, June 4, 2012, available online: http://americanactionforum.org/sites/default/files/The_Economic_Impact_of_the_Medical_Device_Excise_Tax.pdf.
[135] U.S. House of Representatives, Roll Call Vote No. 361, 112th Congress.
[136] U.S. Senate, Roll Call Vote No. 47, 113th Congress.
[137] Internal Revenue Service, *Retirement Topics - IRA Contribution Limits*, page last updated: Jan. 18 2013, available online: http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-IRA-Contribution-Limits.
[138] Internal Revenue Service, *Retirement Topics - 401(k) and Profit-Sharing Plan Contribution Limits*, page last updated: Oct. 25, 2012, available online: http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics---401(k)-and-Profit-Sharing-Plan-Contribution-Limits.

while, contributions to Coverdell education savings accounts are capped at $2,000 per year per intended beneficiary.[139] Individuals who have a health care savings account can contribute up to $3,250 and family accounts have a limit of $6,250.[140]

AFP does not believe that contributions to these accounts should be capped in any way. As was discussed in a previous section, the current disincentives to save in the tax code are substantial.[141] These tax-preferred savings vehicles are merely a partial resolution of that non-neutral treatment of savings. If individuals have a Roth account and want to save more than $5,500 in a given year, then they should be allowed to do so. According to CBO, when contribution limits were raised under the Economic Growth and Tax Relief Reconciliation Act of 2001, the number of individuals constrained by contribution limits fell from 73 percent to 52 percent by 2006.[142] Yet, this raises the question: why have these limits at all since they enforce artificial and arbitrary restrictions upon savers?

Removing the caps also allows individuals to practice income smoothing that avoids the current disincentive to recognize income if it would result in a one-year income spike that could push taxpayers into a higher bracket.

AFP urges Congress to create more neutrality and consistency applied to tax-preferred accounts by eliminating the myriad contribution limits that currently exist. This would reduce the complexity of the current tax code and also offer the individuals the opportunity to increase their personal wealth through savings.

8. Real Estate

8.1. Mortgage Interest Deduction

For the past 25 years, federal tax policy has incented home ownership by providing the mortgage interest deduction. This tax break encourages individuals to pursue more expensive homes at the margin by hiding the true cost of taking on the interest payments associated with more expensive loans.

Originally, as established in 1913, there was no specific mortgage interest deduction. Instead, section 163 "allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."[143] In other words, individuals could deduct interest payments on nearly all consumer debt. In 1986, President Reagan and Congress eliminated a number of tax breaks in order to lower tax rates, including the general interest deduction.[144] Even though other forms of interest payments were eliminated, mortgage interest was not removed. Not only did politicians fear that removing the tax break would result in voter backlash, but they also believed that mortgage interest accomplished the seemingly positive policy goal of increasing home ownership.[145] In 1987, the federal government did limit the amount of deductible mortgage interest to $1,000,000 for interest payments on home loans that are taken out on the borrower's residence.[146] For borrowers who take out loans on non-residential homes, their deduction is capped at $100,000.[147]

Defenders of the deduction argue that it is an important tax break for providing low-income families with an opportunity to achieve homeownership. However, the research simply

[139] Internal Revenue Service, *Coverdell Education Savings Accounts,* IRS Tax Tip 2008-59, page last updated: Sep. 11, 2012, available online: http://www.irs.gov/uac/Coverdell-Education-Savings-Accounts.

[140] Internal Revenue Service, *Publication 969: Contributions to an HSA*, available online: http://www.irs.gov/publications/p969/ar02.html#en_US_2012_publink1000204045.

[141] See *supra*, Part 2.1.1.

[142] Congressional Budget Office, *How Do People Save for Retirement*, Oct. 14 2011, available online: http://www.cbo.gov/publication/42534.

[143] 26 U.S.C. § 163.

[144] Dean Stansel and Anthony Randazzo, *Unmasking the Mortgage Interest Deduction: Who Benefits and by How Much?,* Reason Foundation, Jul. 2011, available online: http://reason.org/files/mortgage_interest_deduction.pdf.

[145] Stansel and Randazzo, *supra* note 144.

[146] 26 U.S.C. § 163(h)(3)(B)(ii).

[147] 26 U.S.C. § 163(h)(3)(C)(ii).

does not support this assertion. Financial policy scholar Peter Wallison argues that since "low-income individuals do not pay any federal income taxes," they receive "no benefit from the mortgage interest deduction."[148] He adds that, "Even families with moderate incomes do not get a benefit from the mortgage interest deduction unless they itemize their tax returns."[149] Consequently, the beneficiaries of the mortgage interest deduction are people of means who do itemize their deductions and who are looking to buy a more expensive home rather than become a first-time homeowner.

Wallison's analysis is supported by research from the Brookings Institution and Reason Foundation. The Brookings Institution notes, the "homeownership rate in the United States has fluctuated in a limited range between 63 and 68 percent since 1950, and several countries without mortgage subsidies have comparable rates of homeownership."[150] Their research also shows that the mortgage interest deduction skews toward favoring wealthy individuals seeking a more expensive residence. Reason Foundation's research confirms this, showing that in 2008, individuals making over $200,000 received roughly $2,221 in mortgage interest deductions whereas individuals making between $50,000 and $75,000 only received about $179 dollars in relief from the provision.[151] One proposed resolution to this effect would be to transition the deduction to a credit, which would thus be available to all taxpayers but would be capped at a certain percentage.[152] This solution would do little to address the underlying issue and would instead make the provision more widely available.

Perhaps the most compelling argument in favor of maintaining the deductibility (or establishing a credit for the full amount) of mortgage interest is neutrality. Heritage Foundation economist J.D. Foster urges that since mortgage interest income is taxable to the lender then it must be deductible to the homeowner or else the same dollar is taxed twice. Since lenders will only provide loans on which they make a profit, this double taxation would cause the interest rate to rise. Therefore, "the tax code would then actively discourage mortgage borrowing, thus violating tax neutrality."[153] Thus, Foster argues, the "home mortgage deduction is then not to create a subsidy for home ownership, but to eliminate a tax bias against home ownership by offsetting the higher mortgage rate caused by the tax on the lender's income."[154] Foster proposes adjusting the home mortgage interest deduction by making it optional. Under this formulation:

> *"Homeowners may deduct mortgage interest, in which case the lender would be taxed on mortgage interest income, thus preserving symmetry and tax neutrality. Alternatively, homeowners may opt to forego the deduction, in which case the lender would not be taxed on mortgage interest income and would then offer a lower mortgage interest rate. This latter option also preserves symmetry and tax neutrality, and also lets the taxpayer self-simplify his tax filing at no cost."*[155]

If this argument regarding neutrality and interest payments is correct, then it would follow that all forms of debt financing should be deductible. The code should then essentially transition back to the pre-1986 formation where all interest payments were deductible under section 163.

That is the not the current treatment; Congress has preferenced home mortgage indebted-

[148] Peter J. Wallison, Bad History, Worse Policy 130 (2013).
[149] Wallison, *supra* note 148, at 130.
[150] Bruce Katz, *Cut to Invest: Reform the Mortgage Interest Deduction to Invest in Innovation and Advanced Industries*, Brookings Institution, Nov. 2012.
[151] Stansel and Randazzo, *supra* note 144.
[152] Shawn Zeller, *Tweaking the Sacred Mortgage Tax Break*, CQ, Nov. 17, 2012, available online: http://public.cq.com/docs/weeklyreport/weeklyreport-000004177540.html.
[153] J.D. Foster, *True Tax Reform: Improves the Economy, Does Not Raise Taxes*, Heritage Foundation, Nov. 2, 2011, available online: http://www.heritage.org/research/reports/2011/11/true-tax-reform-improves-the-economy-does-not-raise-taxes.
[154] Foster, *True Tax Reform*, *supra* note 153.
[155] J.D. Foster, *The New Flat Tax-Easy as One, Two, Three*, Heritage Foundation, Dec. 13, 2011, available online: http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.

ness above other forms of debt. This has led to an overinvestment in housing stock, as the provision lowers the cost of borrowing for homeownership. The country saw firsthand during the 2008 financial crisis what happens when government incentives encourage overinvestment in a particular asset. The mortgage interest deduction did nothing to protect the system from this distortion, and if anything, contributed to the overleveraging and overinvestment in housing. Thankfully, Congress can take meaningful steps to prevent this from happening in the future, including putting an end to the mortgage interest deduction.

AFP encourages Congress to eliminate the mortgage interest deduction in a commonsense and responsible manner. This will likely necessitate a phaseout of the deduction with an exception for mortgage interest that that was incurred before a certain effective date. This will send a clear market signal that it's time for housing prices and investment to return to market equilibrium and that Congress is prepared to slowly transition the tax code to that effect.

9. Conclusion

Tax reform provides Congress with a great opportunity to focus on economic growth. Our current code has numerous provisions that distort both business and individual decision making. These distortions crimp economic growth and are one reason our economy continues to languish. Creating a neutral code that does not punish savings, allows businesses to invest in their capital plant without sacrificing proper calculation of income, protects all industries from being singled out for tax punishment and restores America's international tax competitiveness are core to this challenge. Americans for Prosperity urges Congress to enact comprehensive tax reform that establishes a neutral base, lowers rates and does not increase the net tax burden on Americans.

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