Just Taxes

The CTJ & ITEP Newsletter December 2007

Making Sense of the Tax Fight in Congress

There is plenty of news in the papers today about Congress's battle over taxes, but it often includes terms like "AMT" and "PAYGO" and "carried interest" that are not familiar to most people. With such a complicated subject and so many conflicting viewpoints, it's hard to know what's really going on. Here's a short primer on what Congress is talking about right now.

The current tax debate revolves around the Alternative Minimum Tax (AMT), a sort of backstop tax for the wealthy, meant to ensure that they don't escape paying federal income taxes entirely through the use of loopholes. The exemptions that keep most of us from paying the AMT were never made to rise automatically with inflation, so the AMT has expanded its reach over time. But that's only half the problem. The other half is that the Bush tax cuts have lowered the regular income tax without making any change to the AMT, thus pushing more families onto the AMT. Congress has enacted temporary increases in the exemptions (sometimes called "patches" for the AMT) to keep it under control, but has never enacted a permanent fix.

Republican Leaders Are Shocked – Shocked I Tell You! – That So Many People Will Pay the AMT

Like the police chief in *Casablanca*, some anti-taxers in Congress act as though the expanding reach of the AMT is a complete surprise, that it was never intended to happen, and that therefore we can just repeal the whole thing without replacing the revenue it's supposed to bring in. This is utterly ridiculous. The Bush Administration intentionally left the AMT unchanged so that it would take back part of the Bush tax cuts. This conveniently made the projected cost of the Bush tax cuts appear smaller, but reprehensibly put the AMT on a collision course with the regular income tax. (In fact, the Bush campaign made it clear that their plan would not include an AMT fix even after a 1999 CTJ report brought the looming AMT problem to light.) Subsequently, Republicans controlled the White House and Congress for six years and passed several major tax bills, yet somehow never got around to permanently fixing the AMT.

Now, the Bush Administration's budget plans include the money raised by the AMT after the patch expires. This means that the Administration is assuming, in order to make its budget add up, that the AMT will expand its reach to millions more taxpayers. Of course, those budget plans will become budget *deficit* plans if $800 billion of AMT just disappears. That's why the "pay-as-you-go" (PAYGO) rules that Congress reinstated this year are so important: PAYGO requires Congress to essentially pay for whatever tax cuts it passes rather than just putting it on the national credit card. But the so-called conservatives now argue that Congress should waive PAYGO and repeal the AMT without paying for it. *Continued on page 3*

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December 2007

1616 P Street NW, Suite 200
Washington DC 20036
(202) 299-1066

From the Director's Desk:

Dear Friends,

We hope you enjoyed your fall and are settling in for the winter. Rest assured, CTJ and ITEP are gearing up for what is likely to be a momentous year in the tax reform world.

The Democratic leadership in Congress is starting to unveil its plans for repairing the federal tax system. On both sides of the aisle, a myriad of proposals have been introduced - some that are paid for and some that would increase our $9 trillion debt even more.

Our feature article in this edition of *Just Taxes* takes you through the latest round of the federal tax debate. The article gives a refresher course on how we got in our current fiscal mess, and provides a strong warning that fiscally irresponsible tax proposals may yet prevail unless fairness-minded tax advocates organize themselves to action. That's where the valuable work that we do at ITEP and CTJ has a great impact.

This was another busy year for ITEP at the state level, as we continued to provide timely information about the impact of state tax changes on people at different income levels. Our page five article reviews the biggest (and, more importantly, the most promising) tax trends in states across the nation.

In this edition of the newsletter we've included a CTJ op-ed that was published recently in USA Today. The piece discusses the importance of closing corporate tax loopholes to ensure that the federal corporate income tax can be a fair and sustainable tax. We have many critical problems in this country - and the corporate income tax, if correctly utilized, can be a tool that helps to solve these problems. The op-ed is on page seven.

I'd be remiss if I didn't close by reminding you about our website's "blog." The blog, called "Talking Taxes," is a lively Internet forum in which CTJ and ITEP staff informally discuss various tax issues ranging from carbon taxes to the latest silly state tax deform ideas. It's a timely and entertaining way of staying informed on tax issues. Check it out at www.talkingtaxes.org.

This is also the time of year when you're undoubtedly bombarded with donation requests. We depend on the support of our members. While we are optimistic about our ability to impact federal and state tax debates in 2008, we can't do our work without you.

Thanks for your support throughout 2007.

Bob McIntyre

The Mother of All Tax Reforms... and the Daughter of the Mother of All Tax Reforms

So the new chair of the tax-writing committee in the House of Representatives, Charles Rangel of New York, had a reasonable idea to resolve all this. He realized that the Bush tax cuts have primarily benefitted the wealthy. (Data from CTJ show that the majority of the benefits will actually go to the richest one percent in 2010, when they're fully phased in). So it seemed reasonable to him that the super-rich could give up some of their tax breaks in order to eliminate the AMT, which was threatening to take away a lot of the tax breaks from the middle-income people who received so little of the Bush tax cuts to begin with.

Congressman Rangel introduced a major tax reform bill (H.R. 3970) on October 25 that he called the "mother of all tax reforms." It would repeal the AMT and completely offset the lost revenue. Most of the offset would take the form of a high-income surtax that would reduce the Bush tax cuts for people making over a half a million dollars. Virtually everyone else would come out net winners, thanks to a variety of low- and middle-income targeted tax breaks in the Rangel plan. In November, CTJ released a report praising the bill because it would make the tax code simpler, more progressive and would not increase the federal budget deficit. (The report is available on CTJ's website at www.ctj.org.) And it really seemed like the sort of bill conservatives would like in some ways because it also included a cut in the corporate tax rate, the costs of which would be offset by closing some inefficient corporate tax loopholes that most businesses don't even benefit from.

Conservatives in Congress today refuse to consider any provision that raises revenue in any way – even if it's just to offset the cost of some new tax cuts.

But there is just one problem. Conservatives in Congress today refuse to consider any provision that raises revenue in any way – even if it's just to offset the cost of some new tax cuts. So Congressman Rangel introduced a smaller bill at the same time (H.R. 3996) that would take care of the AMT for a year, giving members of Congress more time to consider his comprehensive tax reform bill.

Republican Leaders Argue Their Own Tax Laws Will Cause the Biggest Tax Increase in History

Now Congress is fighting over this smaller bill, H.R. 3996. On November 9, the House passed this bill, but its fate is unclear in the Senate, where a minority of conservatives can filibuster a bill that has majority support. The bill is revenue-neutral. Its main provision would limit the reach of the AMT for another year by temporarily increasing the AMT exemptions. There are several other provisions, including one to make the Child Tax Credit more available to poor families and others that extend small tax breaks for business. All these costs are offset by provisions that close some egregious loopholes.

And that last bit – the closing of tax loopholes – is what the modern conservative movement cannot abide under any circumstances. They argue that these are tax increases. This bill is only revenue-neutral, they complain, when compared to a baseline assuming that the AMT does expand its reach to more middle-income Americans. But this is the very baseline they used when they ran Congress, and the same baseline that the Bush Administration uses. They're going to start complaining about it now?

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Making Sense of the Tax Fight in Congress

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So conservatives are opposing H.R. 3996 and pressing for Congress to waive PAYGO. They also demand that the key parts of the Bush tax cuts that benefit the rich – like the capital gains and dividends cuts and the estate tax repeal – be made permanent as part of the whole deal. Otherwise, the combination of offsetting the AMT and allowing the Bush tax breaks to expire will lead to the "biggest tax increase in history."

Strangely, conservatives seem to be arguing that the laws they passed will lead to this outcome. The tax breaks passed when conservatives ran both Congress and the White House were written to expire at the end of 2010. They passed several major tax breaks during those six years, and not a single one repealed the AMT or permanently stopped its reach from expanding.

Will the Economy Collapse if We Don't Subsidize Millionaires' Salaries?

The most remarkable part of the story is the tax loopholes that conservatives are defending. H.R. 3996 would offset the costs of AMT relief and other tax breaks by repealing several tax loopholes, one of which is the loophole for "carried interest." This loophole allows fund managers at private equity firms to earn hundreds of millions of dollars a year (and they often do make that much) and yet pay taxes at a lower rate than middle-income people.

Carried interest is a type of compensation they get for managing other people's money. The loophole allows them to pretend that they're investing their own money, which entitles them to the low capital gains tax rate of 15 percent, much lower than the regular income tax rate of 35 percent that other highly-compensated people have to pay on their earnings. Their secretary, on the other hand, might make $42,000 and pay a top income tax rate of 25 percent, on top of the payroll taxes of over 15 percent on all his income.

Lobbyists have convinced a lot of lawmakers – from both parties – that somehow the economy will be harmed if these fund managers have to pay taxes at ordinary income tax rates like everyone else. They are actually arguing that middle-income taxpayers need to continue to subsidize millionaires through the tax code in order to keep the economy running.

> **It's not clear what's scarier, the fact that some people actually believe the conservative arguments, or the fact that they will prevail if progressives don't get moving—and fast.**

The Stakes Are Getting VERY High

It's not clear what's scarier, the fact that some people actually believe the conservative arguments, or the fact that they will prevail if progressives don't get moving fast. We support H.R. 3996 because it addresses the AMT without increasing the budget deficit, and because the revenue-raising provisions are good policy on their own. Closing the carried interest loophole, for example, is something Congress should have done long ago. But if conservatives win this fight and Congress waives the pay-as-you-go (PAYGO) rules, we're all in for a long, scary ride. Once PAYGO has been set aside, there will immediately be calls to set it aside for other proposals – including proposals to extend the Bush tax cuts for the rich. ◆

2007 State Tax Wrap-Up . . . More to Come in 2008

While Congress and the President have devoted considerable time and energy over the past twelve months to critical tax issues such as the Alternative Minimum Tax (AMT) and the treatment of carried interest, state legislatures were no less busy, as some states enacted fundamental reforms to their tax systems, others made important improvements to aid low-income families, and a few began debates over tax policy that may not be resolved until the coming year.

Tax Fairness Wins

Perhaps the most resounding victories for tax fairness this year came in **New York** and **West Virginia**, where state policymakers agreed to begin to use a corporate tax reform known as combined reporting. As CTJ, ITEP, and other organizations have documented, state corporate income taxes have been greatly eroded over time, due in large part to sophisticated tax avoidance schemes devised by highly profitable multi-state companies and their accountants. Many of these schemes center on efforts to shift income – on paper – from one state to another in order to reduce what these companies owe in tax. Combined reporting, which is now used in almost half of the states with corporate income taxes, puts an end to those income-shifting schemes, helping to revitalize state corporate taxes and to create a level playing field for small and big businesses alike. Besides being enacted in New York and West Virginia, combined reporting was seriously considered in seven other states in 2007 and will almost certainly be on the agenda again in 2008.

Big Changes in Michigan

The news out of **Michigan** may have been less uniformly positive, but it was no less impressive in its scope, as elected officials passed not one, but two, sizable tax packages this past year. In March, legislative leaders and Governor Jennifer Granholm hammered out a plan to replace the state's Single Business Tax (SBT) with a new Michigan Business Tax that imposes a tax of 4.95 percent on business profits and a 0.8 percent tax on total receipts less the costs of materials used in production. Then, in October, to help address a projected $1.75 billion budget deficit, they increased the state's single income tax rate from 3.9 to 4.35 percent and broadened the sales tax base to include a variety of services. This latter change has come under immense fire from the business community, which wants the expansion repealed. Doing so would re-open a three-quarter of a billion dollar hole in Michigan's budget, prompting Governor Granholm to oppose any effort that is not revenue-neutral.

Popularity of Low-Income Credits Grows

In a welcome trend, a number of states recognized the importance of enacting low-income refundable tax credits this year. Lawmakers in **Louisiana**, **New Mexico**, and **North Carolina** each put in place a state version of the federal Earned Income Tax Credit (EITC), providing tax reductions for low- and moderate-income workers and their families and taking a vital first step towards offsetting the regressive impact of sales, excise, and property taxes. New Mexico's EITC will equal 8 percent of the federal credit, while both Louisiana's and North Carolina's will amount to 3.5 percent. These actions bring the total number of states now offering some version of an EITC to twenty-three. Just as important, six other states passed legislation expanding their existing EITC's in 2007.

Reforms Debated

A number of other states considered major changes – for good and for ill – to their tax systems in 2007, but ultimately chose not to give those changes the force of law – at least for now. Most notably, in **Illinois**, Governor Rod Blagojevich offered a proposal in March to replace the state's corporate income tax with a gross receipts tax. Though gross receipts taxes may have some merits – such as expanding the base of economic activity subject to taxation – they have a severe shortcoming, in that they have all of the regressive characteristics of a sales tax.

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2007 State Wrap-Up . . . More to Come in 2008

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Given that Governor Blagojevich's proposal would have done away with one of the state's most progressive revenue sources and put a far less fair source in its place, legislators were resoundingly— and rightly— opposed; the Illinois legislature unanimously voted against a resolution in support of the proposal in May, effectively putting the plan out of its misery.

Several other states began important tax debates this year that have yet to be resolved. Voters in **Florida** will decide in January of 2008 whether to make their "Save Our Homes" property tax assessment caps portable and to increase the current homestead exemption – and, in so doing, cut their property taxes by another $12 billion over the next five years. Local governments are understandably aghast. In the meantime, Mitch Daniels, the Governor of **Indiana**, recently put forward an ambitious but seriously flawed property tax measure and **Georgia** Speaker of the House Glenn Richardson continues to tout his troubling plan to repeal that state's property levy.

Better news may soon emerge from **Massachusetts**, as the business tax commission appointed by Governor Deval Patrick and legislative leaders will issue its final recommendations by year's end; that commission has already endorsed one key reform and has expressed support for the principle of mandating combined reporting.

In short, 2008 already promises to be as busy a year for CTJ and ITEP as the past twelve months have proven to be. ◆

Close Loopholes, Fix Problems

As published in USA Today; September 17, 2007

By Robert McIntyre, CTJ's Director

Almost everybody (except corporate lobbyists) agrees that America's corporate income tax is a mess. According to the Bush Treasury Department, corporate loopholes will cost ordinary taxpayers almost $2 trillion over the upcoming decade. And, Treasury adds, these tax subsidies are hurting our economy by shifting investments away from more productive uses.

Suppose we could close some or all of these destructive loopholes. What should we do with the huge sums we'd save?

One option, supported by President Bush and USA TODAY, is to give the money right back to corporations, by lowering the corporate tax rate. But that approach would make a cruel joke out of corporate tax reform.

After six years of huge deficits to support high-income tax cuts and war spending, our nation's finances are in terrible shape. Meanwhile, tens of millions of Americans lack health insurance, our roads and bridges are crumbling, and the impending baby-boomer retirement will soon put additional major strains on the federal budget.

The revenues raised from corporate tax reform could be—and should be—a key to solving these critical problems.

Arguing otherwise, supporters of cutting the corporate tax rate assert that our corporate taxes are "uncompetitive" because they're higher than in other nations. But that's a ridiculous claim. To be sure, our official rate— the 39 percent federal and state rate that big companies are supposed to pay— is slightly higher than the 36 percent norm among our major trading partners. But that theoretical rate is pretty meaningless because our plethora of tax subsidies lets companies pay U.S. taxes on only half their actual profits!

In fact, because of the explosion in loopholes, U.S. corporate taxes as a share of our economy have plummeted. We now rank 27th out of 29 countries.

The bottom line is that closing harmful corporate loopholes and using the revenues to address our nation's fiscal problems is a win-win solution—one that will benefit all of us, not just big corporations. ◆

Tell a Friend!

Our members are our greatest resource. Help us spread the word about our work to your friends and family—and with anyone else who may be interested in learning more about the impact of recent tax changes at the federal and state level.

Share this newsletter with them!

ITEP welcomes a new staff member

We're excited to welcome Jeff McLynch, formerly with the Massachusetts Budget and Policy Center, to ITEP's research team. He comes to ITEP with a wealth of knowledge on federal and state tax issues. Jeff joined our staff in January and is directing ITEP's research and analysis efforts in our Northeast Office in Boston.

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FREDERICK MD
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Citizens for Tax Justice
Institute on Taxation & Economic Policy
1616 P Street, NW
Suite 200
Washington, DC 20036

202.299.1066
888.626.2622 (toll-free)
e-mail: ctj@ctj.org
www.ctj.org
www.itepnet.org

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Looking Forward to 2008

This has been a difficult year in the tax world. As a nation we continued to fall further in debt (a debt that now amounts to $9 trillion), while many states struggled with budget deficits. We anticipate that 2008 will be a challenging year for our busy team of analysts and researchers. We burn the candle at both ends to help fight poverty and restore fairness to our tax system. This has been a difficult task in recent years, but there are glimpses of change in the air: at the state level, lawmakers are enacting promising reforms to help low-income families and restore corporate accountability. And in Washington, the Congressional leadership has unveiled a tax reform plan that would help undo the damage from the Bush tax cuts.

Unlike most organizations, CTJ and ITEP do very little direct solicitation of its members. We simply stick a card and return envelope into our quarterly newsletter and hope that you—the readers, our members—will want to return them to us with a check enclosed. We know that people don't like to be bothered with constant reminders to make contributions. But, once a year, we need to ask. So, please, remember us when you are making your annual donations and know that because we are small your dollars have so much more impact.

Thank you for your help, and best wishes for 2008.

The staffs of CTJ and ITEP: Alla, Bob, Bonnie, Ed, Jeff, Kelly, Matt and Steve