# Tax Loopholes and Expenditures: An Analysis

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ABSTRACT

"Loophole" is a term that is often misused by politicians and the general public to criticize tax incentives such as the preferential capital gains tax rate and the charitable contributions deduction. This use of the term is imprecise because of the underlying implication that those using the law as it is intended are "cheating the system." Most of these tax incentives are actually tax expenditures passed by the government to subsidize specific groups or activities. Because both tax expenditures and loopholes reduce the tax liability of their beneficiary legally, the line separating the two seems very thin. The purpose of this thesis is to end current misconceptions by examining the history, effects and future implications of both tax expenditures and actual tax loopholes, while drawing a defining line between the two. The ambiguity of certain cases will demand the use of reasonable judgment to infer whether a particular law is being exploited. Although the topic of tax loopholes has a significant role in the political arena, this thesis will avoid any political debate. As such, opinions regarding the effectiveness, viability or purpose of any particular tax law will not be addressed, but they will be mentioned where relevant.

# CHAPTER 1 - INTRODUCTION

What is a tax loophole?  It appears to be a subjective term, having a different meaning depending on who is asked.  One could say that one person's loophole is another's tax reform.[1]  If one were to ask someone in the general public to define a tax loophole, the definition would likely criticize the tax breaks provided to the wealthy.  To some, a loophole refers either to the legislation originating from wealthy businesses lobbying for their own benefit, or to the discrepancy between the tax breaks the rich receive and those the general public receive.  To others, a loophole is a discovery made by hired lawyers scanning the law for even the tiniest mistake to exploit.  The purpose of this thesis is to end the confusion regarding the meaning of a tax loophole, arguing more in support of the latter.

***Loopholes: A Brief Survey***

The most popular usage of the term is to criticize tax incentives that tend to benefit the wealthy, such as the preferential capital gains rate.  This use of the term is flawed and imprecise because it implies that taxpayers using the tax incentives as they were intended are exploiting the system.  For the purpose of this thesis, a tax loophole is an unforeseen omission or flaw in a tax law that can be exploited to legally reduce a taxpayer's tax liability in a manner that either contradicts or exceeds the law's original intent.  In a sense, a tax loophole is the misuse of a tax law, not the tax law itself.  It is important to note that tax loopholes are perfectly legal to use; fault lies in the government rather than the user for its exploitation.  This is distinct from tax evasion, where the law is broken to avoid the payment of taxes and the violator is subject to

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1 This concept was discussed in Powell, J.  (2012, March 7).  The Pleasures And Perils of Tax Loopholes.  *Cato Institute*.  Retrieved from http://www.cato.org/publications/commentary/pleasures-perils-tax-loopholes.

prosecution. It is also important to notice the difficulty in determining a law's original intent. A law's true intent can never be known with complete certainty. For this thesis, reasonable judgment will be exercised to infer the original intent of a law.

One example of a tax loophole is the exploitation of the Qualified Plug-In Electric and Electric Vehicle Credit. This was a nonrefundable tax credit enacted as Internal Revenue Code (IRC) § 30D by the Energy Improvement and Extension Act of 2008 and later amended by the American Recovery and Reinvestment Act of 2009 .[2] This tax credit rewarded taxpayers for acquiring a plug-in electric drive motor vehicle based on its vehicle weight rating, battery capacity and manufacturer[3] but ironically benefited taxpayers buying golf carts as well. The law, according to its definition of motor vehicles, does not allow vehicles "manufactured primarily for off-road use, such as primarily for use on a golf course"[4] but because the golf carts could still be sold as "neighborhood electric vehicles," many taxpayers and businesses were still able to take advantage of the tax credit.[5] IRC § 30D, which awarded a $2,500 tax credit at minimum and $7,500 at maximum,[6] had the potential to provide a large enough tax credit for taxpayers to effectively purchase golf carts for free[7], provided that they had a large enough tax liability to reduce. This use of the tax credit is considered a loophole because it can be inferred that the credit was not intended to benefit golf carts, let alone make them essentially free.

2 PL 111-5 American Recover and Reinvestment Act §1143, amending IRC § 30D

3 IRC §30D

4 See 2009-48 Internal Revenue Bulletin

5 See Kristof, K. (2009, December 21). Free Golf Cart—But Call It A "Low-Speed Neighborhood Vehicle". *CBS News MoneyWatch.* Retrieved from http://www.cbsnews.com/news/free-golf-cart-but-call-it-a-low-speed-neighborhood-vehicle/.

6 PL 109-59, § 11113, 119 Stat. 1144

7 See Kristof, K. (2009, December 21). Free Golf Cart—But Call It A "Low-Speed Neighborhood Vehicle". *CBS News MoneyWatch.* Retrieved from http://www.cbsnews.com/news/free-golf-cart-but-call-it-a-low-speed-neighborhood-vehicle/.

Another example of a tax loophole is commonly known as the "black liquor credit." The loophole is the result of the "Volumetric Excise Tax Credit For Alternative Fuels" which is a refundable tax credit created as a part of the SAFETEA-LU (Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users).[8] The tax credit, which reduced the user's tax liability by 50 cents per gallon of alternative fuel, included "liquid hydrocarbons derived from biomass"[9] which ironically also applied to "black liquor." "Black liquor" is a byproduct of the wood pulping process used by paper companies to power their mills. Because paper companies have been using "black liquor" as fuel since the 1930s, the companies received massive tax breaks without ever needing to change their business process.[10] In 2009 for example, International Paper received a $540 million tax credit from the use of "black liquor."[11] In total, the U.S. Treasury paid $8 billion to paper companies in 2009.[12] Although the loophole was finally closed in 2010, its beneficiaries were able to keep the credits they received in previous years.[13] In addition, companies in later years have amended their older tax returns to acquire "black liquor" tax refunds from the past.[14] The reason why the "black liquor credit" was a loophole is because it awarded a massive tax credit without having any influence on the paper

8 PL 109-59, § 11113, 119 Stat. 1144
9 Id.
10 See Mufson, S. (2009, March 28). Papermakers Dig Deep in Highway Bill to Hit Gold. *Washington Post.* Retrieved from http://www.washingtonpost.com/wp-dyn/content/article/2009/03/27/AR2009032703116.html.
11 See Fickes, K. & Joseph, W. (2013). 10 notorious tax loopholes. *Bloomberg.* Retrieved from http://money.msn.com/taxes/10-notorious-tax-loopholes.
12 See Mufson, S. (2013, July 19). When it comes to the paper industry and fuel tax credits, IRS looks like a soft touch. *Washington Post*. Retrieved from http://articles.washingtonpost.com/2013-07-19/business/40671473_1_black-liquor-paper-industry-refunds on page 1.
13 See Fickes, K. & Joseph, W. (2013). 10 notorious tax loopholes. *Bloomberg.* Retrieved from http://money.msn.com/taxes/10-notorious-tax-loopholes.
14 See Mufson, S. (2013, July 19). When it comes to the paper industry and fuel tax credits, IRS looks like a soft touch. *Washington Post*. Retrieved from http://articles.washingtonpost.com/2013-07-19/business/40671473_1_black-liquor-paper-industry-refunds on page 2.

companies' future actions. The tax credit was most likely originally passed to encourage an *increased* use of alternative fuels, as opposed to rewarding businesses for the *continued* use of an old business practice.

Another tax loophole, which is still in effect as of the time of writing, originated with the court case “Quill Corp. v. North Dakota, By And Through Its Tax Commissioner, Keitkamp.” The court case, decided by the Supreme Court in 1992,[15] would have very significant tax implications in the years that followed. Quill Corporation is a successful direct marketer of office products in the United States that has been incorporated since 1956.[16] At the time of the court case, the corporation was a mail-order company which refused to collect the use tax imposed on them by North Dakota. John E. Gaggini, the advocate for Quill Corporation, referenced National Bellas Hess v. Illinois, which ruled that mail order sellers were not required to collect sales tax unless it had some physical contact with the state.[17] Nicholas Spaeth, advocate for North Dakota, argued that Quill Corporation *did* have economic presence through their ownership interest in the computer software their customers used to purchase their products. The Supreme Court ultimately reversed the judgment of the North Dakota Supreme Court, ruling that a business *must* have *physical* presence in a state in order for that state to require the business to collect sales taxes.

This would inevitably result in the Internet sales tax dilemma currently in dispute. Amazon.com, inc., a worldwide Internet retailer selling a wide variety of goods by itself and

15 Quill Corporation v. North Dakota, By and Through its Tax Commissioner, Keitkamp, 504 U.S. 298 (1992).
16 See *Quill Corporation.* (1999). *International Directory of Company Histories, Vol.28*, pp. 375-377.
17 National Bellas Hess v. Department of Revenue of State of Illinois. 386 U.S. 753 (1967).

through third parties, only collects sales tax in 16 states[18] in the U.S. because it lacks physical presence in the other states. This has provided Amazon.com with a significant competitive advantage over other businesses because of their ability to reduce the effective sales price of a product with the elimination of sales tax. Local businesses and employees competing against online retailers are effectively 5 to 10 percent behind assuming they match their competitor's price.[19] The reason this is a loophole is because online retailers like Amazon.com have a large economic presence that competes even against local businesses, yet does not pay sales taxes like their local competitors. The Quill Corp v. North Dakota ruling that allows them to operate without collecting sales taxes was decided in the context of a mail-order retailer, and did not consider the advances in technology that allow retailers like Amazon.com to instantly sell, and quickly deliver their products to its customers without physical presence in their customers' respective states.

***Tax Expenditures: A Brief Survey***

Loopholes are easy to confuse with tax expenditures, which are tax incentives passed by the government to subsidize specific groups or activities. These expenditures—commonly criticized as loopholes—are the tax credits, deductions, preferential rates and other tax preferences included in the tax code that "represent departures from a 'normal' tax code."[20] A "normal" tax code would only tax each taxpayer's increase in net wealth plus consumption per

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18 A list of these states, as well as other relevant sales tax information is displayed on Amazon.com's website at http://www.amazon.com/gp/help/customer/display.html?nodeId=468512

19 See Milchen, J. (2011, April 28). To Help Main Street, Close the Internet Sales Tax Loophole. *Bloomberg Businessweek*. Retrieved from http://www.businessweek.com/smallbiz/content/apr2011/sb20110428_074924.htm

20 See McBride, W. (2013, August 22). A Brief History of Tax Expenditures. *Tax Foundation*. Retrieved from http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff391.pdf.

period;[21] any special provisions for specific groups or actions would be considered a "departure." Tax expenditures are recognized as a method of spending because the government's tax revenue is reduced in order to provide monetary support similar to a government subsidy.[22] The concept of tax expenditures started in the United States in 1968,[23] and has since then expanded to the point that every Congressional budget has a section for tax expenditures.[24] The U.S. Treasury's "dollar value estimate of the tax expenditure budget for 2013 is about $1.2 trillion."[25] The advantage of spending though tax expenditures as opposed to direct spending is that tax expenditures are easier to implement, require less government supervision, and go into effect much more quickly.[26]

Tax expenditures can appear in various forms, but can generally be classified into three categories. The first is the "social welfare" category. These expenditures tend to assist lower-income taxpayers in forms such as the earned income tax credit and the child and dependent care credit. Also included in this category are education tax credits, such as the American Opportunity Tax Credit and the Lifetime Learning Credit. The second and smallest category is considered "corporate welfare," and consists of the provisions subsidizing certain industries and activities. These expenditures tend to encourage renewable energy and energy-efficiency in

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21 Referring to the Schanz-Haig-Simons (S-H-S) definition of income, covered in McDaniel, P. R., & Surrey, S. S. (1985). *Tax Expenditures.* Cambridge, Massachusetts, and *London, England: Harvard University Press.*

22 Id on page 3.

23 Id on page v.

24 Id on page 1.

25 See McBride, W. (2013, August 22). A Brief History of Tax Expenditures. *Tax Foundation*. Retrieved from http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff391.pdf.

26 Much of these benefits directly result from the fact that taxpayers must apply for these tax expenditures on their own. The concept is discussed in more detail in Surrey, S. S. (1970 February). Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures. *Harvard Law Review, Vol. 83, No. 4., pp. 705-738.*

forms such as the Residential Energy Efficient Property Credit and the Plug-in Electric Drive Vehicle Credit. The third and largest category encourages saving by mitigating the double taxation of savings and investment and making exclusions for retirement contributions and earnings.[27] These expenditures are the most likely to be mistaken for loopholes and include the preferential treatment for capital gains and dividends.

The two main criticisms of tax expenditures are that they are an inefficient form of spending when compared to direct spending and benefit the wealthy much more than the typical taxpayer. Although tax expenditures are passed to stimulate certain activities, their costs normally outweigh their benefits.[28] Many expenditures pay taxpayers just for proceeding as they normally would have without them, such as the interest and dividend tax rates. As a result, there will always be wasted tax revenue even if these expenditures were to function with 100% efficiency otherwise (which, unfortunately, is hardly ever the case). One of the main sources of criticism for the preferential capital gains rate is the fact that the tax expenditure has not made much of an impact on investment or economic growth, while remaining a large expense of taxpayer dollars.[29] Unfortunately, it is impossible to create a tax system that avoids this problem without making the system overly complicated.[30]

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27 McBride, W. (2013, August 22). A Brief History of Tax Expenditures. *Tax Foundation*. Retrieved from http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff391.pdf. discusses these three categories in more detail.

28 See McDaniel, P. R., & Surrey, S. S. (1985). *Tax Expenditures.* Cambridge, Massachusetts, and *London, England: Harvard University Press.* page 82.

29 See the graph in Plumer, B. (2012, January 19). Do low taxes on capital gains spur growth? Not necessarily. *Washington Post*. Retrieved from http://www.washingtonpost.com/blogs/wonkblog/post/do-low-taxes-on-capital-gains-spur-growth-not-necessarily/2012/01/19/gIQAJZ4yAQ_blog.html. The capital gains rate fluctuates up and down, yet investment continues to grow at a steady rate.

30 See Surrey, S. S. (1970 February). Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures. *Harvard Law Review, Vol. 83, No. 4, pp. 705-738.*

Tax expenditures—especially for individuals—also tend to progressively benefit higher-income taxpayers over other taxpayers. In fiscal 1977, "the top 1.4 percent of taxpayers received 31.3 percent of the assistance delivered through tax expenditures."[31] It is no different today, where "eliminating tax expenditures would reduce after-tax income by 11.4 percent" for the top quintile of taxpayers.[32] Because higher-income taxpayers have more money to work with, it is easier for them to qualify for tax expenditures the regular taxpayer would not. Itemized deductions, including the home mortgage interest deduction, charitable contributions, property taxes and the deduction for medical and dental expenses, demonstrate this concept well.[33] In order for a taxpayer to benefit from itemizing deductions, the taxpayer must deduct a large enough total dollar value in items to surpass the standard deduction.[34] Wealthier taxpayers can afford more expensive medical care, accrue mortgage interest on multiple homes, pay higher property taxes, and contribute large amounts to charity. Other tax expenditures such as the capital gains rate also disproportionally benefit the wealthy, with an "estimated 94 percent of the tax benefit of low rates from capital gains" going to taxpayers with "cash incomes over $200,000".[35]

Although many tax expenditures do disproportionately benefit higher-income taxpayers,

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Retrieved from http://www.jstor.org/stable/1339837. on page 719

31 See McDaniel, P. R., & Surrey, S. S. (1985). *Tax Expenditures.* Cambridge, Massachusetts, and London, England: Harvard University Press. page 71.

32 See Burman, L. E., Geissler C., & Toder, E. J. (2008, May). How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?. *The American Economic Review, Vol. 98, No.2, pp.79-83*. Retrieved from http://www.jstor.org/stable/29729999 on page 83.

33 See Internal Revenue Service. (2012). *Schedule A (Form 1040): Itemized Deductions*. Retrieved from http://www.irs.gov/pub/irs-pdf/f1040sa.pdf

34 For reference, the standard deduction in 2013 is $6,100 for single taxpayers, $12,200 for married taxpayers. Internal Revenue Service. (2013). *Form 1040: U.S. Individual Income Tax Return.* Retrieved from http://www.irs.gov/pub/irs-dft/f1040--dft.pdf

35 See Burman, L. E., (2011, June 22). Capital Gains and Dividends: What is the effect of a lower tax rate?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/capital-gains/lower-rate.cfm.

lower-income taxpayers also receive a considerable amount of tax benefits that have their own flaws. The Earned Income Tax Credit (EITC) for example, is a source of a fair amount of criticism regarding the effects of tax policy and social welfare. The EITC program, introduced in 1975 during the presidency of Gerald Ford, was a small program focused on low-income families with children until its expansion in 1979 to a larger range of incomes and its subsequent expansions in the following years.[36] In 1975, the cost of the EITC was about $1.47 million.[37] By comparison, the EITC today, if eliminated, would "increase tax revenues by $56 billion" and "increase GDP by $34 billion."[38] In today's form, the EITC is a refundable tax credit provided to *working* taxpayers (whether self-employed or employed by someone else) with an annual earned income under $13,980 for single taxpayers without children.[39] It is considered one of the "federal government's largest and most effective antipoverty programs" today,[40] reducing the poverty rates for the elderly from 25.3 to 20.8 percent and reducing child poverty from 22.3 to 19.1 percent in 1996.[41] Several studies have also found that "the EITC encourages some people

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36 See Liebman, J. B. (1998, January). The Impact of the Earned Income Tax Credit on Incentives and Income Distribution. *National Bureau of Economic Research, Vol. 12,* pp. 83-120. Retrieved from http://www.nber.org/chapters/c10914. on page 86-87.

37 Id. on page 86. "The cost of the EITC represented only 7 percent of the $21 billion stimulus bill signed by President Ford in 1975."

38 See Entin, S. J. & Schuyler M. (2013, August 6) Fiscal Fact No. 385: Case Study #7: The Earned Income Tax Credit. *The Economies of the Black Slate.* Retrieved from http://taxfoundation.org/article/case-study-7-earned-income-tax-credit

39 The income range can be increased depending on whether the taxpayer has children or is married. At maximum, the credit can benefit taxpayers with income under $50,270 if they are married with at least 3 children. Internal Revenue Service. (2012). *Instructions for Form 1040 and Schedules A, B, C, D, E, EIC, F and SE.* Retrieved from http://www.irs.gov/pub/irs-pdf/i1040.pdf

40 See Forman, J. B. Earned income credit. *The Encyclopedia of Taxation and Tax Policy.* Retrieved from http://www.urbaninstitute.org/UploadedPDF/1000524.pdf on page 100.

41 See Liebman, J. B. (1998, January). The Impact of the Earned Income Tax Credit on Incentives and Income Distribution. *National Bureau of Economic Research, Vol. 12,* pp. 83-120. Retrieved from http://www.nber.org/chapters/c10914.

to enter the workforce who otherwise would not."[42]

The EITC has been criticized as a secretive method of wealth redistribution by some, with the subsequent tax refunds resulting in the payout of up to $6,044 per family.[43] By others, the EITC has been criticized as an ineffective or flawed tax incentive and welfare program. Although the EITC provides incentives for low-income workers, many taxpayers seem to be unaware that they can claim it, which raises the question of what effect the EITC actually has on employment. The EITC had a participation rate "between 80 and 86 percent" in 1990, meaning that approximately "2 million families eligible for the credit in 1990 failed to obtain it."[44] This could be attributed to the complexity of correctly filing for the credit. Two-thirds of low-income parents require assistance to prepare their federal tax return, typically having to pay tax preparers.[45] The EITC also has a high error rate, with about $13 billion to $15.5 billion in EITC claims being paid out in error annually.[46] In addition, because the inclusion of a spouse's income reduces the credit that spouses could have earned separately,[47] the EITC discourages the spouses of working parents from looking for work and also creates an incentive for divorce.[48]

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42 See Entin, S. J. & Schuyler M. (2013, August 6) Fiscal Fact No. 385: Case Study #7: The Earned Income Tax Credit. *The Economies of the Black Slate.* Retrieved from http://taxfoundation.org/article/case-study-7-earned-income-tax-credit.

43 See Carasso A. & Maag, E. (2013, January 12). Taxation and the Family: What is the Earned Income Tax Credit?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/family/eitc.cfm

44 See Forman, J. B. Earned income credit. *The Encyclopedia of Taxation and Tax Policy.* Retrieved from http://www.urbaninstitute.org/UploadedPDF/1000524.pdf on page 100.

45 See Carasso A. & Maag, E. (2013, January 12). Taxation and the Family: What is the Earned Income Tax Credit?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/family/eitc.cfm

46 Id.

47 Id. This concept is also known as the "marriage penalty"

48 See Congressional Research Service. (2010, December). *Tax Expenditures: Compendium of Background Material on Individual Provisions.* (111th Congress 2d Session, S. PRT. 111-58, 62-799cc). Washington, DC: U.S. Government Printing Office. on page 891.

Furthermore, because the EITC only benefits *working* taxpayers, it does not benefit poor taxpayers who do not work, but they can still benefit from other social welfare programs to avoid work.

It should be noted that tax expenditures, even when flawed, should not be criticized as loopholes. The distinction between loopholes and expenditures is important because of the different connotation each term has. Criticizing a law as a loophole implies that the law is not being implemented correctly and needs to be amended for better accuracy. On the other hand, criticizing a law as a tax expenditure implies that tax revenue is not being spent correctly. If one were to criticize the home mortgage interest deduction for example, it would be more precise to argue against it as an inefficient or inequitable form of spending, than to call it a tax loophole that is being exploited. Likewise, it would be more accurate to argue against the earned income credit's effectiveness as a work incentive, than to slander it as a loophole for the poor. There are numerous valid arguments that can be made against tax expenditures for any political view without the use of the word "loophole." Unfortunately, the word "loophole" is often used to advance misleading political arguments against tax expenditures.[49][50] This thesis will not discuss the wide range of possible political arguments, but may mention some of them where relevant.

Confusion arises when there are circumstances where it is difficult to differentiate loophole from expenditure. An example of this is the use of the Child and Dependent Care Tax

49 Here is an example of a right-wing use of the word loophole as a criticism of the EITC: White, T. (2012, April 17). Tax Loophole? Let's End the Biggest Loophole of All – the "Earned" Income Tax Credit. *Virginia Right*. Retrieved from http://www.varight.com/opinion/tax-loopholes-lets-end-the-biggest-loophole-of-all-the-earned-income-tax-credit/

50 Here is an example of a left-wing use of the word loophole to criticize the preferential capital gains rate and the home mortgage interest deduction: Bell, K. Tax loopholes that mainly benefit the rich. *Bankrate.com*. Retrieved from http://www.bankrate.com/finance/taxes/tax-loopholes-mainly-benefit-rich-1.aspx

Credit (CDCTC) for summer camp expenses. The CDCTC is a nonrefundable tax credit that allows the beneficiary to claim a tax credit for a portion of *employment-related* child and dependent care expenses.[51] *Employment-related* means that the aforementioned expenses were paid so that the taxpayer can either work or look for work.[52] It can be inferred that the purpose of this credit is to alleviate the financial stress of parents (especially single parents) that have to pay for dependent care in order to work. The reason why deducting summer camp expenses is controversial is because children are normally sent to summer camp either for their development or for their own personal enjoyment. They are not normally sent to summer camp for *employment-related* purposes. Under normal circumstances, the deduction of summer camp expenses would be considered a loophole. However, the Internal Revenue Service (IRS) surprisingly *does* allow the use of the CDCTC to deduct summer camp expenses, but only for summer *day* camp; expenses for overnight camps are not qualified.[53] Therefore, this use of the CDCTC would actually be a tax expenditure, because the IRS had intended for this use of the law. However, the use of the CDCTC for *overnight* summer camp expenses would be a loophole. Because the IRC was amended in 1987 to prohibit the use of overnight camp,[54] it can be inferred that the IRS did not intend for the CDCTC to be used for that purpose.

Both tax expenditures and tax loopholes, despite being distinct from each other, are still

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51 See Anderson, E. A. & Forry N. D. (2006). The Child and Dependent Care Tax Credit. *Marriage & Family Review, Vol 39, No. 1-2,* pp. 159-176. Retrieved from: http://dx.doi.org/10.1300/J002v39n01_09

52 See Internal Revenue Service. (2013). *Publication 503: Child and Dependent Care Expenses.* Retrieved from http://www.irs.gov/pub/irs-pdf/p503.pdf

53 See Internal Revenue Service. (2011, July 6). Summer Day Camp Expenses May Qualify for a Tax Credit. *IRS Summertime Tax Tip 2011-01.* Retrieved from http://www.irs.gov/uac/Summer-Day-Camp-Expenses-May-Qualify-for-a-Tax-Credit

54 See Fickes, K. & Joseph, W. (2013). 10 notorious tax loopholes. *Bloomberg.* Retrieved from http://money.msn.com/taxes/10-notorious-tax-loopholes.

departures from an ideal tax code.  They are both likely to remain as topics of strong controversy. This introductory chapter highlighted the issues of both, which will be demonstrated in further detail in subsequent chapters.  The next chapter will examine three of the most prominent loopholes, all of which have made a significant impact on the popular press.

## CHAPTER 2 – LOOPHOLES: DISCUSSION AND ANALYSIS

The most prominent tax loopholes in the popular press are those that benefit politicians and rich individuals and large corporations. The controversial image of well-off individuals and business entities receiving additional government support is enough to get the public involved. Many of these tax loopholes have a historical origin but are not exploited until some years later. It could be said that loopholes are not created but discovered. What is remarkable about these particular tax loopholes is that—despite their discovery and continuous use—very little (at the time of writing) has been done by the government to address them.

### *The S Corporation Tax Shelter*

An S Corporation—named such because the rules for its tax treatment are found under Subchapter S of Chapter 1, Subtitle A, of the Internal Revenue Code (IRC)—is a pass-through entity similar to a partnership, meaning that the corporation's "income, deductions, losses, and credits (…) are passed through to the separate returns of its owners, who generally are subject to taxation."[55] This treatment prevents double-taxation because the corporation's earnings are only taxed at the shareholder level. According to §1361, the S Corporation is a "small business corporation" that makes an election under §1362(a) in order to receive this tax treatment.[56] An eligible "small business corporation" is defined as a domestic corporation that does not have more than 100 shareholders, a shareholder who is not an individual (other than certain exceptions such as estates), a nonresident alien as a shareholder, nor have more than 1 class of stock.[57] It should be noted that single-shareholder corporations also qualify for subchapter S treatment.

55 See Anderson, K. E., Bandy, D. D., Ford, N. A., Fowler, A. C., Henderson, C., Hulse, D. S., Schadewald, M. S. (2013). *Prentice Hall's Federal Taxation 2013*. Pearson. Page 2-6 Corporations.

56 All shareholders must consent to this election. "Election" means that the corporation can decide against organizing as a subchapter S corporation even if it qualifies for subchapter S status.

57 §1361(b)

In 1959, soon after the enactment of S Corporation rules in 1958,[58] the IRS issued Revenue Ruling 59-221, part of which reads:

> Where a small business corporation elects under section 1372 of the Internal Revenue Code of 1954 not to be subject to federal income tax, the amounts of its income which are required to be included in each shareholder's gross income do not constitute 'net earnings from self-employment' to such shareholder for Self-Employment Contributions Act purposes.[59]

This ruling decided that self-employment tax would not apply to a shareholder's allocation of business income from an S corporation it owns. It also determined that "income not resulting from the conduct of a trade or business" is not included in the computation of an individual's self-employment tax.[60] The consequence of this ruling is the continuing double-standard between S corporations and similar business structures that *do* require the payment of self-employment taxes, such as partnerships and sole proprietorships. S corporation shareholders are still required to pay FICA taxes for salaries paid to them by the S corporation in their role as employees of said corporation. However, controlling shareholders can decide to pay themselves less in salaries while receiving more income in distributions from the corporation, which are free from the self-employment tax. This essentially means that an S corporation shareholder can pay less in taxes than a partner while receiving the same amount of income and holding the same ownership interest. Because the burden is on the IRS to determine whether a shareholder is

58 See Nellen, A. (2010, June 10). Self-Employment Tax Policy Considerations. *AICPA Store*. Retrieved from http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2010/Tax/TaxPolicyConsiderations.jsp.

59 Revenue Ruling 59-221, 1959-1 C.B. 225

60 Id.

properly reporting reasonable salaries,[61] many opportunistic shareholders are reporting smaller salaries than would normally be paid for the work they had done. With there being so many S corporations, it is impossible for the IRS to scrutinize every single one.

In order to more easily demonstrate these tax consequences, assume two potential business owners named Gerry and Jannyl are faced with a decision between forming a partnership or an S corporation together. The two would have equal partnership interest or shares (50%) while being the sole owners of the hypothetical business, which would earn $200,000 in the year 2013 as a direct result of their actions. In both scenarios, both of the owners receive $100,000 in income allocated to them from their business and reported on their individual income tax returns. Gerry wants to form a partnership. As a partner, Gerry would pay income taxes on his $100,000 share of the profits. Assuming he is taxed as a single individual, he would be liable for $21,293 in income taxes.[62] Then, he must also pay self-employment (SE) taxes on the same $100,000 of income. The total SE tax is $100,000 x 92.35% (SE income) x 15.3% (SE tax rate) = $14,130.[63] The SE tax effect is mitigated by the self-employment tax deduction for half of the SE tax liability, in this case for $7,065.[64] Because this is a tax *deduction*, and not a credit, the tax liability is actually reduced by only $7,065 x 28% (the taxpayer's tax bracket) = $1,978. Gerry would then have a total tax liability of $21,293 + $14,130 - $1,978 = $33,445.

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61 See Gardiner, P. J. (2005, May 20). Actions Are Needed to Eliminate Inequities in Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (Reference Number 2005-30-080). Retrieved from http://www.treasury.gov/tigta/auditreports/2005reports/200530080fr.html.

62 Amount calculated and then rounded using Schedule X from Internal Revenue Service. (2013). *Instructions for Form 1040: Including Instructions for Form 8949 and Schedules 8812, A, C, D, E, F, R, and SE.* Retrieved from http://www.irs.gov/pub/irs-pdf/i1040.pdf. on page 101.

63 Calculated using rates from Internal Revenue Service. (2013). *Schedule SE (Form 1040): Self-Employment Tax.* Retrieved from http://www.irs.gov/pub/irs-pdf/f1040sse.pdf

64 Id.

In contrast, Jannyl wants to form an S corporation, which would only require them to pay SE taxes on the amount paid to them in salaries for their roles as corporate employees. Assume that Jannyl reports that the S corporation paid her $20,000 in salary for 2013. The total amount of income that is subject to income taxes remains the same at $100,000, with $20,000 being characterized as salary compensation and the remaining $80,000 being characterized as a taxable allocation from the corporation. The taxable allocation is still subject to income taxes, but not to employment taxes. Therefore, she would still pay $21,293 in income taxes as a shareholder. Jannyl and the corporation would only pay employment taxes on the $20,000 of salary compensation. Jannyl, as an employee, would pay for her half (7.65% FICA tax) amounting to $20,000 x 7.65% = $1,530 while the corporation pays the other half for another $1,530. Jannyl's total tax liability would then be $21,293 + $1,530 (Jannyl's half) + $1,530 (the corporation's half) = $24,353. There is no SE tax deduction because the corporation is Jannyl's employer in this case. Compare this to the total tax liability of $33,445 when a partnership entity is used. The result is a potential $9,092 reduction in tax liability solely based on the way the business is organized.

It is not certain when the loophole was actually discovered, but the number of taxpayers exploiting the S corporation tax shelter has steadily increased over the years since Revenue Ruling 59-221. In tax year 1994 for example, S corporation shareholders on average paid themselves salaries equal to 47.1 percent of their profits.[65] In contrast, shareholders paid themselves 41.5 percent of their profits on average in tax year 2001.[66] The tax shelter has also

65 See George, J. R. (2005, May 25). Statement of J. Russel George Inspector General: Treasury Inspector General for Tax Administration Before the Senate Finance Committee. Retrieved from http://www.treasury.gov/tigta/congress/congress_05252005.pdf on page 2.

66 Id.

led to an increasing number of sole proprietors incorporating as single-shareholder S corporations. In tax year 2000, 69.4 percent of all S Corporations were fully owned by a single shareholder.[67] Some of these taxpayers are bold enough to avoid paying self-employment taxes entirely. In the year 2000, "36,000 single-shareholder S corporations with profits of $100,000 or more passed through profits of $13.2 billion to their sole owners without paying any employment taxes."[68] These opportunists gamble on the fact that very few S corporation returns are actually examined from year to year. In 2002, only approximately 0.39% of all S corporation returns were actually examined, with a continuing downward trend since.[69]

Despite this fact, there are still a few taxpayers who face the U.S. Tax Court for paying themselves unreasonable compensation. One recently ruled case is Sean McAlary Ltd, Inc. v. Commissioner of Internal Revenue. Sean McAlary Ltd, Inc. was an S corporation solely owned by Sean McAlary, a real-estate broker[70]. McAlary managed all aspects of his corporation's operations, including hiring and supervising sales agents (who operated as independent contractors receiving commission), conducting real estate sales, purchasing supplies and maintaining the books and records by working 12-hour days with few days off.[71] Regardless of these facts, in 2006 McAlary paid himself a salary of zero while transferring about $240,000 to himself from his corporation's account.[72] His corporation's net income was $231,454.[73] When

67 See Gardiner, P. J. (2005, May 20). Actions Are Needed to Eliminate Inequities in Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (Reference Number 2005-30-080). Retrieved from http://www.treasury.gov/tigta/auditreports/2005reports/200530080fr.html.

68 Id.

69 Id.

70 See Caron, P. (2013, August 31). Tax Court Rejects Small Business Owner's Use of 'John Edwards Sub S Tax Shelter.' *Law Professor Blogs Network*. Retrieved from http://taxprof.typepad.com/taxprof_blog/2013/08/tax-court-rejects-.html

71 See Sean McAlary Ltd., Inc. v. Commissioner of Internal Revenue. Docket No. 21068-11S. (2013, August 12). Retrieved from http://www.ustaxcourt.gov/InOpHistoric/McAlary.SUM.WPD.pdf

72 Id. on page 7.

the IRS challenged McAlary, he claimed that his base salary was $24,000.[74] The IRS refuted his claim, determining that the fair value of McAlary's services for his corporation was approximately $48.44 per hour, or about $100,755 annually.[75] As a result, McAlary was liable for the employment taxes he owed on the $100,755, in addition to penalties assessed under §6651(a)(1) and §6656 of the IRC.[76]

The most noteworthy uses of the tax shelter are from the politicians John Edwards (D) and Newt Gingrich (R), whose actions subsequently exposed the loophole to the public. The tax shelter became known as the "John Edwards loophole" in 2004 when Edwards was a vice-presidential candidate. It was discovered that Edwards, who campaigned for higher taxes on the wealthy while being wealthy himself, had used this tax loophole in the past to avoid paying employment taxes.[77] In 1995, John Edwards was a trial attorney who was the sole shareholder of the S corporation he formed that year named John R. Edwards, P.A.[78] Edwards, who earned $26.9 million in 1995, only paid himself $360,000 in salary each year.[79] The net result was FICA tax savings of about $591,000.[80]

The tax loophole fell under public scrutiny again after Newt Gingrich released his 2010 tax return. Robert E. McKenzie, a partner in the law firm Arnstein and Lehr LLP reviewed

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73 Id. on page 7.
74 Id. on page 13.
75 Id. on page 16. This assumed that McAlary worked 40 hours per week for the entire year.
76 Id. on page 17. The penalty is up to 25% of the tax owned under §6651(a)(1) and an additional 10% under §6656.
77 See Caron, P. (2004, July 14). Wall Street Journal Charges Kerry-Edwards with Tax Hypocrisy. *Law Professor Blogs Network.* Retrieved from http://taxprof.typepad.com/taxprof_blog/2004/07/wall_street_jou_1.html.
78 See Closing the "John Edwards" Loophole Helps, Not Hurts, Small Business. (2010, June 15). *Citizens for Tax Justice.* Retrieved from http://www.ctj.org/pdf/johnedwardsloophole.pdf on page 2.
79 See Hupalo, P. I. (2003). S Corporations Help Small Business Owners Save On Taxes. Retrieved from http://www.thinkinglike.com/S-Corporation/John-Edwards-Saved-With-S-Corporation.html
80 Id. Edwards was above the wage limit for the Social Security portion of employment taxes, so only the Medicare tax rate is applicable in calculating his tax savings. The self-employment tax deduction was also factored out in calculating his tax savings because Edwards would have received it if he was instead a sole proprietor.

Gingrich's tax return and revealed his use of the loophole to Forbes, which soon after became public knowledge.[81] Gingrich, who owned S corporations Gingrich Holdings, Inc. and Gingrich Productions, reported only $444,327 as salaried compensation, while the remaining $2.4 million was treated as a distribution of profits, saving him about $50,000 in FICA taxes.[82]

Despite the numerous examples of the tax loophole's exploitation over the years, it still exists to this day. The government's inaction regarding this matter could be seen as implying that the S corporation's employment tax advantage is intended, which would classify this as a tax expenditure. However, the reaction of J. Russel George, Treasury Inspector General for Tax Administration (TIGTA), suggests otherwise. In 2005, the TIGTA issued a statement regarding the inequitable tax treatment of S corporations compared to other similar businesses.[83] In it, he argues against IRS Revenue Ruling 59-221, contending that their treatment of S corporations was based on the assumption that all S corporations would have multiple shareholders or owners. In an S corporation with many shareholders, the salary of any particular owner would have to be decided with consensus, which would eliminate (or at least alleviate) this tax issue. The TIGTA also criticizes how the ruling forces the IRS address the issue of determining reasonable compensation for an S corporation shareholder on a case-by-case basis.[84] The IRS disagreed, stating that Revenue Ruling 59-221 was based on the longstanding law that considers corporations separate taxable entities, and arguing that the ruling was not the cause of the

81 See Caron, P. (2012, January 2012). Newt Gingrich Used 'John Edwards Sub S Tax Shelter' to save $50k in Medicare Taxes. *Law Professor Blogs Network.* Retrieved from http://taxprof.typepad.com/taxprof_blog/2012/01/newt-gingrich-used-.html

82 Id.

83 This is referring to George, J. R. (2005, May 25). Statement of J. Russel George Inspector General: Treasury Inspector General for Tax Administration Before the Senate Finance Committee. Retrieved from http://www.treasury.gov/tigta/congress/congress_05252005.pdf

84 Id. on page 2.

inequities that the TIGTA mentioned.[85] They continued by asserting that the TIGTA overstated the S corporation's status as a tax shelter while referencing the IRS's ability to electronically filter taxpayer returns for auditing.[86]

There was one point that TIGTA, the IRS, and the Joint Committee on Taxation (JCT) agreed on. The S corporation tax shelter clearly provides inequitable treatment to taxpayers in similar circumstances.[87] The reason why it still has not been addressed is because government officials disagree on the source of the inequities. While the TIGTA believes that Revenue Ruling 59-221 is the source, the IRS and the JCT believe that pass-through entity rules in general are the source, and that a more global approach to tax reform would resolve the issue.[88]

### *The Carried Interest Loophole*

“Carried interest” is a tax loophole that originated from the birth of private investment funds such as private equity funds and hedge funds. Private investment funds are typically structured either as limited partnerships or limited liability companies (LLC), consisting of multiple limited partners and one general partner. The limited partners (LPs) are investors who all pool their financial capital into the fund.[89] The general partner (GP) is a firm of investment professionals (which is typically also a partnership) who manage the capital raised by the LPs, deciding where it should be invested.[90] In return for managing the fund and contributing 1 to 5

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85 See Gardiner, P. J. (2005, May 20). Actions Are Needed to Eliminate Inequities in Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (Reference Number 2005-30-080). Retrieved from http://www.treasury.gov/tigta/auditreports/2005reports/200530080fr.html. Appendix V

86 Id.

87 Id. The TIGTA mentions that the Joint Committee on Taxation share his concerns. The IRS in their response acknowledged and agreed with his concerns.

88 Id. The IRS refers to the JCT's report, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05).

89 See Aron-Dine, A. (2007, August 1). An Analysis of the "Carried Interest" Controversy. *Center on Budget and Policy Priorities.* Retrieved from: http://www.cbpp.org/files/7-31-07tax.pdf on page 3.

90 See Batchelder, L. & Rosenthal, S. (2013, February 7). Business Taxation: What is carried interest and how

percent of the funds initial capital, the GP receives compensation in a two part package.[91] The first part is a fixed management fee for a percentage of the total amount of financial capital in the fund, typically around 2 percent.[92] The second part is "carried interest," which is 20 percent of the fund's profits that exceed a set "hurdle" rate of return,[93] often set at 8 percent. All income earned by the GP is then allocated to its own partners, who are generally individuals who are professional investment managers. The management fee is taxed like wage and salary income (an income tax rate of up to 39.6 percent) whereas carried interest is taxed as capital gains (a rate of up to 20 percent).[94] There is no dispute over the taxation of the management fee, but carried interest has become a controversial tax issue.

There are two main arguments for why it is considered inappropriate to tax carried interest as capital gains. The first is that the GP is not financially at risk enough to deserve the capital gains rate on the investment fund's profits.[95] Because private investment funds are either limited partnerships or LLCs, they are treated as pass-through entities for the purposes of taxation. This means that when the fund generates profits in the form of capital gains (which they often do), the profits are passed through to the partners as capital gains.[96] The GP receives 20 percent of these capital gains profits from carried interest, but only contributes 1 to 5 percent of the fund's capital. As a result, the GP is treated as a 20 percent partner tax-wise, despite only

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should it be taxed?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm.

91 See Cunningham, N. B. & Engler, M. L. (2007). The Carried Interest Controversy: Let's Not Get Carried Away. *Benjamin N. Cardozo School of Law: Jacob Burns Institute for Advanced Legal Studies, Working Paper No. 211.* Retrieved from http://ssrn.com/abstract=1040801 on page 6.

92 Id.

93 See Batchelder, L. & Rosenthal, S. (2013, February 7). Business Taxation: What is carried interest and how should it be taxed?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm.

94 Id.

95 See Aron-Dine, A. (2007, August 1). An Analysis of the "Carried Interest" Controversy. *Center on Budget and Policy Priorities.* Retrieved from: http://www.cbpp.org/files/7-31-07tax.pdf on pages 5-6.

96 Id. on pages 4-5.

being 1 to 5 percent at risk. The second argument is that the GP is clearly performing a service for the fund, and the carried interest is clearly compensating the GP for it.[97] The GP's primary role is day-to-day management, and *not* investment, but its tax treatment is not a reflection of such. The existence of carried interest has resulted in inequitable tax treatment between private investment fund managers and other types of managers, whose roles and forms of compensation are similar.[98] Another way to look at the GP's compensation package is as a performance-based salary, with a fixed management fee and carried interest as a bonus based on the investments' success. This is not too different from corporate CEOs who typically receive a fixed management fee and a bonus in the form of stock options, which increase in value as the company succeeds.

The tax effect of carried interest is more clearly demonstrated with an example. Suppose for this example that there is a private equity fund named PEF, which operates as a limited partnership. PEF has multiple LPs who contribute 99% of the capital in the fund and one GP who contributes the remaining 1%. The GP is a partnership consisting of two investment professionals named Ed and Jim, who are equal partners in the GP. In return for managing the day-to-day operations of PEF, the GP receives a management fee for 2% of PEF's assets, as well as "carried interest" equal to 20% of PEF's profits above the "hurdle" rate of return, which is set at 8%. Currently, PEF has a total of $100 million invested in various areas, including many publicly traded companies. Therefore, the management fee paid to the GP is equal to $2 million

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97 Id. on page 5.

98 There is also another issue regarding carried interest about the timing of taxation. Because capital gains are not recognized until realized, carried interest is not taxed when the GP's rights to future profits have been granted. More on this issue can be found in: *The Taxation of Carried Interest:* CBO Testimony before the Committee of Finance, *United States Senate*. (2007, July 11). (Testimony of Peter R. Orszag). Retrieved from http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/83xx/doc8306/07-11-carriedinterest_testimony.pdf on page 7.

(2% of $100 million). Ed and Jim, being equal partners, are each allocated $1 million from the GP. This $1 million is reported on each of their individual tax returns as ordinary income and taxed at a 39.6% tax rate. It is also subject to self-employment tax.

Over the course of the year, PEF experiences a 20% return on their $100 million of investments, amounting to $20 million in profits. All of these profits are either qualified dividends or long-term capital gains. Because the “hurdle” rate is 8%, $100 million x 8% = $8 million is subtracted from the profits in calculating carried interest. This $8 million is allocated to the LPs owning 99% of the partnership. The GP's carried interest is therefore equal to 20% of the remaining $12 million of profits, or $2.4 million. This $2.4 million is allocated to the GP while the other $9.6 million is allocated to PEF's LPs, giving them a total of $17.6 million. Within the GP, Ed and Jim are each allocated $1.2 million of carried interest, taxed at 20%. This means Ed and Jim each pay $1.2 million x 20% = $240,000 in taxes on the carried interest income. If the carried interest was instead taxed as salaried income, Ed and Jim would instead pay $1.2 million x 39.6% = $475,200, in addition to self-employment taxes on the $1.2 million. Because of the current tax treatment of carried interest, Ed and Jim benefit from significant tax savings.

The issue of carried interest taxation was brought to the public's attention during the political career of eventual Republican presidential candidate Mitt Romney. Romney was discovered to have been a partner and founder of Bain Capital since 1984.[99] Bain Capital is a private equity firm comprising partners from the business consulting firm Bain & Company,

99 See Pappu, S. (2005, September). The Holy Cow! Candidate. *The Atlantic Monthly*. Retrieved from http://www.theatlantic.com/magazine/archive/2005/09/the-holy-cow-candidate/304196/3/ on page 3.

including Romney.[100] Bain Capital, in its role as the GP, would manage the assets supplied by various investors—including pensions, foundations, endowments and individuals—and make investments in publicly traded companies.[101] Bain Capital would then provide business consulting for investee companies to improve business operations, ensuring that investments in them would pay off.[102] Bain Capital, being a private equity firm (or GP), would receive carried interest as part of its compensation and allocate it to its partners.[103] This resulted in Romney having a 15 percent overall tax rate, which became a major source of controversy during the 2012 presidential election. Because of Bain Capital's secretiveness regarding its investments (which is common for most private equity firms), it is difficult to find detailed numbers on its carried interest.[104] However, the otherwise obscure issue of carried interest was unveiled when the release of Romney's 2010 tax returns revealed that he received carried interest from Bain Capital in his ten-year retirement package with the company.[105][106]

The reason why carried interest has not been dealt with through tax reform is because there is no consensus on how carried interest should be treated, or whether it should even be treated at all. One dispute is about whether carried interest has a role in the corporate

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100 Id.

101 See About Bain Capital. *BainCapital.com.* Retrieved from http://www.baincapital.com/about-bain-capital on February 7, 2014.

102 Id.

103 See Scherer, R. (2012, January 19). Unlocking the mystery of Romney's 15 percent tax rate. Yes it's legal. *The Christian Science Monitor*. Retrieved from http://www.csmonitor.com/USA/Elections/President/2012/0119/Unlocking-the-mystery-of-Romney-s-15-percent-tax-rate.-Yes-it-s-legal

104 See Hagey, K. Mitt Romney's Bain Capital days: A black box. *Politico.* Retrieved from http://www.politico.com/news/stories/0112/71344.html on February 5, 2014.

105 See Healy, B. & Kranish, M. (2012, July 20). Romney kept reins, bargained hard on severance. *Boston.com.* Retrieved from http://www.boston.com/news/politics/articles/2012/07/20/romney_kept_reins_bargained_hard_on_severance/?page=full on February 7, 2014.

106 There are other issues regarding Romney's relations with Bain Capital that will not be covered in this thesis. These include the effects of his departure from Bain Capital in 1999, and the question of how involved he was in Bain Capital's investment decisions.

environment. A common defense for carried interest is that the GP's compensation "carries a lot of risk," and that the low capital gains rate compensates for this risk.[107] This defense is normally refuted by comparing the GP's salary to the performance-based compensation of other managers. For example, Peter Orszag, 7th Director of the Congressional Budget Office (CBO) has the perspective that "the character of carried interest income should not depend on whether the compensation is performance-based."[108] The issue of whether the tax code should subsidize risk merits its own separate topic, but is irrelevant to the issue of carried interest. Orszag's argument also refutes other common defenses, such as those that argue for carried interest either as a subsidy for entrepreneurial labor or as method of offsetting double corporate taxation.[109] Experts worry that reforming carried interest would hurt investors and venture capital firms or force them to move overseas.[110] The flaw with this argument is that there are other similar businesses that are not receiving the same tax benefits.

There is also a dispute about the character of carried interest. Although many sources would agree that carried interest represents a payment for services rendered, there is still disagreement on how much of it should be characterized as such. Recall that the GP of a private equity firm contributes 1 to 5 percent of the investment fund's capital. This means that at least some of the GP's profits share is a result of capital gains. The question of how much is difficult to answer because of the "hurdle" rate that the GP must surpass. It could be argued that the

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107 See Aron-Dine, A. (2007, August 1). An Analysis of the "Carried Interest" Controversy. *Center on Budget and Policy Priorities.* Retrieved from: http://www.cbpp.org/files/7-31-07tax.pdf on pages 6-7.

108 See *The Taxation of Carried Interest:* CBO Testimony before the Committee of Finance, *United States Senate*. (2007, July 11). (Testimony of Peter R. Orszag). Retrieved from http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/83xx/doc8306/07-11-carriedinterest_testimony.pdf

109 See *Tax Reform, Tax Arbitrage, and the Taxation of "Carried Interest"*: Before the Committee on Ways and Means, *U.S. House of Representatives.* (2007, September 6). (Testimony of C. Eugene Steuerle). Retrieved from http://www.urban.org/UploadedPDF/901112_steuerle_carried_interest.pdf on pages 4-5.

110 See Aron-Dine, A. (2007, August 1). An Analysis of the "Carried Interest" Controversy. *Center on Budget and Policy Priorities.* Retrieved from: http://www.cbpp.org/files/7-31-07tax.pdf on pages 9-13.

"hurdle" lowers the salaried part of the carried interest payment.[111]

If reaching a consensus is difficult, choosing a method of tax reform may be doubly so. Numerous experts have offered varying approaches to reforming carried interest. One suggestion is to treat the GP's partners as though they had received an interest-free non-recourse loan to "purchase" the carried interest.[112] This would make the GP's partners taxable at an ordinary rate (up to 39.6%) for the hypothetical interest rate (assumed to be the market rate) this "loan" would have as its "interest" accrues.[113] In addition, the partners would still be taxed on their distributions from the GP based on the character of the income (normally capital gains for private equity firms).[114] This is a middle-ground approach where GP's partners are taxed more than they are currently (pure capital gains), but less than if all of the carried interest was characterized as ordinary income. An example of a more extreme approach is the Levin Proposal, a popular proposal created by Representative Sander Levin (D-MI) which suggests that *all* amounts received from carried interest should be treated as wage and salary income.[115] This would tax all carried interest income as ordinary income once realized. According to the JCT, the potential benefit of taxing carried interest like wage and salary income would be about a $15 billion increase in tax revenue.[116] However, if tax reform is not implemented correctly, GPs

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111 See Batchelder, L. & Rosenthal, S. (2013, February 7). Business Taxation: What is carried interest and how should it be taxed?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm.

112 See Batchelder, L. (2008, June 25). What are the options for reforming the taxation of carried interest?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest-reform.cfm.

113 Id.

114 Id.

115 See Cunningham, N. B. & Engler, M. L. (2007). The Carried Interest Controversy: Let's Not Get Carried Away. *Benjamin N. Cardozo School of Law: Jacob Burns Institute for Advanced Legal Studies, Working Paper No. 211*. Retrieved from http://ssrn.com/abstract=1040801 on page 8.

116 See Batchelder, L. & Rosenthal, S. (2013, February 7). Business Taxation: What is carried interest and how should it be taxed?. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm.

could produce strategies that mitigate the tax effects of the reform,[117] or worse, the reform could have unintended effects on other industries.

***The Amazon Tax Loophole***

In the case of the Amazon Tax Loophole, its status as a loophole is widely agreed upon, yet its treatment still varies by state. As mentioned in Chapter 1, the worldwide Internet retailer Amazon.com, inc. only collects sales tax in 16 states in the U.S. because it lacks “physical presence” in the other states. This physical presence is known as “nexus,” a requirement originating from the Commerce Clause of the U.S. Constitution and the Due Process Clause of the 14th Amendment.[118] States do not have the authority to tax persons, property or transactions that do not have a “definite link” known legally as “substantial nexus” with the state.[119]

The Quill Corp v. North Dakota ruling established that “substantial nexus” specifically meant “physical presence” in the state. In Amazon's case, this includes their fulfillment centers and customer service centers. This “physical presence” interpretation by the court means that Internet retailers like Amazon are not required to collect sales taxes in states where they sell goods, yet still have no physical presence.[120] The result is the inequitable tax treatment between Internet retailers and brick-and-mortar businesses as well as the ongoing confusion regarding interstate commerce. The National Conference of State Legislatures estimated that at least half of the $23 billion lost from uncollected taxes originated from Internet sales.[121] At the time of

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117 Id.

118 See Congressional Research Service. *CRS Annotated Constitution.* Washington, DC: U.S. Government Printing Office. Retrieved from http://www.law.cornell.edu/anncon/html/art1frag54_user.html

119 Id.

120 This also affects physical stores who sell additional goods through their websites and mail-order businesses who do not own websites but deliver to customers in other states.

121 See Barnes, R. (2013, December 2). Supreme court denies case on making online retailers collect sales taxes. *The Washington Post.* Retrieved from http://www.washingtonpost.com/politics/supreme-court-declines-case-on-making-online-retailers-collect-sales-taxes/2013/12/02/e430ec8c-55f5-11e3-835d-

writing, the Internet sales tax continues to be a highly litigated tax issue.

In 2008, New York became the first state to legislate what would become known as "click-through nexus" or the "Amazon rule," forcing Amazon.com to collect sales taxes in a state where it was not physically located.[122] This was accomplished by revising the definition of "vendor" (the entity collecting sales taxes) to include Internet retailers who have affiliates residing in New York advertising for the retailer for a commission on sales, known as "associates programs".[123] This definition targets large Internet retailers, whose affiliates maintain links to them on their websites in exchange for a percentage of the sales proceeds.[124] The Amazon Associates program, launched in 1996, allows Amazon.com affiliates to place links to Amazon on their websites while earning up to an additional 15% on the sales proceeds as a referral fee.[125] Amazon also provides the tools for affiliates to create an online store featuring Amazon products.[126] Because Amazon is a more established and recognizable brand, affiliates are more likely to sell their products by referring to Amazon.

The enactment of click-through nexus had the potential to hurt these affiliates' sales. In response, Amazon.com and Overstock.com challenged the constitutionality of click-through nexus on the grounds that it violated the Commerce and Due Process Clauses.[127] However, the

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e7173847c7cc_story.html

122 See Burkard, A., DiDonato M., Jones, C., Melone, R., Stolly, L., & Yesnowitz, J. C. (2013, December 10). United States: U.S. Supreme Court Declines to Consider Whether New York's Click-Through Nexus Statute is Facially Constitutional. *Mondaq Business Briefing.*

123 Id. This is also known as "performance marketing."

124 Id.

125 More information on the program can be found in: What is the Amazon Associates program?. *Amazon Associates.* Retrieved from https://affiliate-program.amazon.com/gp/associates/join/getstarted?ie=UTF8&pf_rd_i=assoc_join_getstarted_fourth&pf_rd_m=ATVPDKIKX0DER&pf_rd_p=&pf_rd_r=&pf_rd_s=assoc-right-1&pf_rd_t=501&ref_=amb_link_376201502_1

126 Id.

127 See Burkard, A., DiDonato M., Jones, C., Melone, R., Sutton, G., & Yesnowitz, J. C. (2013, April 18). United States: New York State Court Of Appeals Holds Click-Through Nexus Statute Is Facially Constitutional. *Mondaq Business Briefing.*

New York State Court of Appeals found click-through nexus constitutional, forcing Overstock.com to subsequently terminate its associates program.[128] Among the terminated associates were NextJump, a provider of employee benefit programs and Entertainment Publishing, printer of discount coupon books.[129] Since then, click-through nexus has been enacted by Arkansas, California, Connecticut, Georgia, Illinois, North Carolina, Rhode Island and Vermont and proposed in many other states.[130]

However, not all of the states necessarily agreed with New York's ruling on click-through nexus. After click-through nexus was enacted in Illinois as IL Public Act 096-1544, the Performance Marketing Association (the PMA), a trade association representing businesses engaged in performance marketing, filed a complaint against the Illinois Department of Revenue.[131] The PMA challenged the constitutionality of click-through nexus by using the Commerce Clause and referencing the Quill Corp. v. North Dakota ruling.[132] They further added that the Internet Tax Freedom Act (ITFA), being a federal law, preempts the state statute of click-through nexus.[133] The ITFA, in addition to preventing taxes on Internet access, prohibits discriminatory taxes on Internet transactions, including the obligation to collect sales tax.[134] Because click-through nexus specifically targets Internet retailers, the PMA argues that the

128 See Burkard, A., DiDonato M., Jones, C., Melone, R., Stolly, L., & Yesnowitz, J. C. (2013, December 10). United States: U.S. Supreme Court Declines to Consider Whether New York's Click-Through Nexus Statute is Facially Constitutional. *Mondaq Business Briefing.*

129 See Hansell, S. (2008, May 14). Overstock.com Throws New York Affiliates Overboard to Avoid Sales Tax. *New York Times: Bits.* Retrieved from http://bits.blogs.nytimes.com/2008/05/14/overstockcom-throws-new-york-affiliates-overboard-to-avoid-sales-tax/

130 See Burkard, A., DiDonato M., Jones, C., Melone, R., Sutton, G., & Yesnowitz, J. C. (2013, April 18). United States: New York State Court Of Appeals Holds Click-Through Nexus Statute Is Facially Constitutional. *Mondaq Business Briefing.* Note 16

131 Performance Marketing Ass'n v. Hamer. IL 114496 (2013).

132 Id.

133 Id.

134 See Illinois Supreme Court Holds Click-Through Nexus Statute Preempted By Internet Tax Freedom Act. (2013, October 25). *Mondaq Business Briefing.* Retrieved from http://bi.galegroup.com.ezproxy.lib.usf.edu/essentials/article/GALE%7CA346923045/f101dfdbfbe0a04a940d3a

statute should be invalidated by the ITFA. The Circuit Court of Cook County agreed with both points made by the PMA.[135] Upon direct appeal, the Supreme Court of Illinois affirmed the preemption of the ITFA over click-through nexus and agreed that click-through nexus constituted a discriminatory tax, but did not address the Commerce Clause claim.[136]

The inconsistent tax treatment of Internet retailers called for several attempts to universally decide on how Internet sales tax should be handled. In 2011 alone, three bills addressing Internet sales and use tax collection were introduced in the United States Senate and the House of Representatives. These bills were the Main Street Fairness Act of 2011, the Marketplace Fairness Act of 2011 and the Marketplace Equity Act of 2011.[137] All three bills proposed the collection of sales taxes by states who have entered the Streamlined Sales and Use Tax Agreement (SSUTA)[138] from out-of-state vendors, but in slightly differing ways.[139] The Main Street Fairness Act of 2011 required sales tax collection from all remote sellers except those exempted by a governing board and provided minimal simplification.[140] The Marketplace Equity Act of 2011 exempted sellers with less than $1 million in remote sales and required that states provide a single tax base.[141] The Marketplace Fairness Act of 2011 was the middle-ground between the other two, exempting sellers with less than $500,000 in remote sales and

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135 See Lee, Z. (2013, October). Illinois Supreme Court Holds Federal Law Preempts Click-Through Nexus Law." *Mondaq Business Briefing.* Retrieved from http://bi.galegroup.com.ezproxy.lib.usf.edu/essentials/article/GALE%7CA346923094/f101dfdbfbe0a04a940d3a2795c16918
136 Id.
137 National Retail Federation. n.d. *Sales Tax Fairness: Three Opportunities on the Table*. [Comparative Chart] Retrieved from http://blog.nrf.com/wp-content/uploads/2011/11/sales-tax-fairness-one-pager.png
138 SSUTA is an agreement among certain states to make sales and use taxes more uniform, predictable, fair and neutral. As of 2011, there are 24 states participating in the agreement. More can be read on SSUTA here: Streamlined Sales and Use Tax Agreement (2013, October 30). Retrieved from http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA_As_Amended_10-30-13.pdf
139 Id.
140 Id.
141 Id.

determining a tax rate based on the destination of the sale.[142] All three bills eventually expired without being enacted.[143]

Another opportunity to permanently settle the issue arose after Amazon's challenge on click-through nexus in New York was dismissed by the New York State Court of Appeals. After appealing to the New York Supreme Court, who affirmed the decisions of the Court of Appeals,[144] Amazon finally petitioned for a writ of certiorari to take the case to the U.S. Supreme Court.[145] The Supreme Court denied Amazon's writ of certiorari in December of 2013 without issuing any explanation.[146] In an e-mailed statement to FOXBusiness.com, Amazon revealed that "the Supreme Court already has addressed the sales tax issue, saying in (an earlier ruling) that Congress can and should act to resolve it."[147] Currently, Amazon supports the Marketplace Fairness Act of 2013,[148] which would require sellers with remote sales exceeding $1 million to collect sales and use taxes for all remote sales regardless of physical presence.[149] It would also simplify the collection of sales and use taxes by providing a "uniform sales and use tax base for all state and local taxing jurisdictions," adopting a "uniform rule for sourcing all remote sales," and providing free software that "calculates sale and use taxes, files tax returns, and updates tax

142 Id.

143 Id.

144 See Burkard, A., DiDonato M., Jones, C., Melone, R., Sutton, G., & Yesnowitz, J. C. (2013, April 18). United States: New York State Court Of Appeals Holds Click-Through Nexus Statute Is Facially Constitutional. *Mondaq Business Briefing.*

145 Amazon.com, LLC v. New York State Department of Taxation and Finance. NY 13-259 (OT 2013).

146 See Novack, J. (2013, December 2). Happy Cyber Monday; Supreme Court Won't Hear Amazon Sales Tax Appeal. *Forbes.* Retrieved from http://www.forbes.com/sites/janetnovack/2013/12/02/happy-cyber-monday-supreme-court-wont-hear-amazon-sales-tax-appeal/

147 See Prial, D. (2013, December 2). U.S. Supreme Court Won't Hear Online Sales Tax Case. *FOXBusiness.* Retrieved from http://www.foxbusiness.com/industries/2013/12/02/us-supreme-court-wont-hear-online-sales-tax-case/

148 See Graham, C. (2013, November 1). Why Amazon Fights State Sales Tax, But Supports It Nationally. *Technology Advice.* Retrieved from http://technologyadvice.com/why-amazon-fights-state-sales-tax-but-supports-it-nationally/

149 Marketplace Fairness Act of 2013. S.743, 113th Congress (2013-2014). Was also originally introduced as H.R.684, and then as S.336.

rate changes."[150] "Remote sales" are defined as the sale of goods or services that would not require the collection of sales and use taxes without the Marketplace Fairness Act.[151] The $1 million requirement for remote sales essentially decides that the size of a remote seller's *economic presence* can be used as a form of substantial nexus. The Act passed through the senate by a vote of 69 – 27 with the support of both Democrats and Republicans but, as of the time of writing, it is still pending enactment.[152]

There are many who question Amazon's motivations for suddenly supporting a bill that would remove their sales tax advantage. It should be considered that while Amazon supports the Marketplace Fairness Act of 2013, it aggressively fought state sales tax laws in the past,[153] sometimes threatening to shut down distribution centers and eliminate jobs.[154] Some experts speculate that a universal sales tax benefits Amazon in the long term. Amazon's business model has always been to reinvest all of their profits into additional infrastructure, resulting in continuing quarterly losses.[155] Therefore, as Amazon continues to expand to additional states, having a universal sales tax becomes more beneficial. Other experts question whether sales tax avoidance is even an advantage for Amazon. Because sales taxes are paid by the consumer, sales tax collection would only hurt Amazon if it affected their sales. However, according to a survey of more than 2,600 Texans, there was little or no change in buyer habits after Amazon began

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150 Id.
151 Id.
152 Id.
153 See Graham, C. (2013, November 1). Why Amazon Fights State Sales Tax, But Supports It Nationally. *Technology Advice*. Retrieved from http://technologyadvice.com/why-amazon-fights-state-sales-tax-but-supports-it-nationally/
154 See Byrnes, N. (2012, April 27). Sales-tax deal with Texas is Amazon's latest. *Reuters*. Retrieved from http://www.reuters.com/article/2012/04/27/net-us-amazon-tax-sales-idUSBRE83Q1D320120427
155 See Yarow, J. (2013, October 28). Former Amazon Employee Explains How The Company's Business Model Really Works. *Business Insider*. Retrieved from http://www.businessinsider.com/amazons-profits-what-people-dont-understand-2013-10

collecting sales taxes in Texas.[156] There are also some who argue that the Marketplace Fairness Act of 2013 hurts Amazon's competition. E-commerce websites Etsy and eBay lobbied against the Act, arguing that it would "impose serious costs and inconvenience for small sellers."[157] eBay wants the $1 million threshold pushed up to $10 million, adding that "small online vendors struggle to compete with behemoths like Amazon."[158]

While it may be considered unethical to exploit a tax loophole, recall that the use of a loophole is completely legal. As such, a taxpayer's use or support of a tax loophole cannot be used to judge their motivations or intentions. The burden is on the government to remove loopholes, not on the taxpayers to avoid them. In many cases, such as with the S Corporation Tax Shelter and Carried Interest, the tax loopholes continue to benefit taxpayers because government officials do not agree on a method of reform. The Amazon Tax Loophole endured for years because states could not agree on what constitutes substantial nexus. The loophole may finally be closed by the Marketplace Fairness Act in the future, but other loopholes will likely not see the same treatment because of their inherent complexity. The next chapter will discuss three tax expenditures that are commonly mistaken for tax loopholes by the popular press. Although tax expenditures can be exploited in a way that constitutes a loophole (such as receiving a home mortgage interest deduction for owning a yacht), they are not tax loopholes by themselves.

156 See Bensinger, G. (2012, September 17). The Sales-Tax Effect on Amazon: Nada. *Wall Street Journal: Digits.* Retrieved from http://blogs.wsj.com/digits/2012/09/17/the-sales-tax-effect-on-amazon-nada/

157 See Robertson, A. (2013, May 6). Senate passes nationwide online sales tax bill. *The Verge.* Retrieved from http://www.theverge.com/2013/5/6/4304764/senate-passes-marketplace-fairness-act-online-sales-tax-bill

158 See Song, K. M. (2013, May 7). Internet sales-tax bill backed by Amazon passes Senate. *The Seattle Times.* Retrieved from http://seattletimes.com/html/localnews/2020932508_amazontaxxml.html

## CHAPTER 3 – TAX EXPENDITURES: DISCUSSION AND ANALYSIS

Tax expenditures, like loopholes, have gained infamy in the public press primarily because of the rich individuals and corporations that use them. They are typically criticized for unfairly favoring the wealthy or not having their intended effect, while being completely legal to use. The public often confuses some tax expenditures for loopholes because of their similarities. The following tax expenditures have a long history with the U.S. tax code, yet continue to be branded as loopholes for this reason.

Recall from Chapter 1 that tax expenditures, even when flawed, are not necessarily loopholes. Tax loopholes are unintended, unforeseen consequences resulting from an omission or flaw in a tax law. Tax expenditures, on the other hand, are a method of government spending used to subsidize a group or activity through reducing tax liability. However, they do not always create the desired effect because of how they are designed.

### ***The Home Mortgage Interest Deduction***

American taxpayers could always deduct mortgage interest on their tax returns, but it was not originally its own separate tax expenditure. After the creation of the modern federal income tax in 1913, *all forms* of interest payments were deductible on the individual income tax return on the grounds that "interest payments were an expense of earning business and investment income."[159] There was no distinction between mortgage interest and interest from loans in the tax code.[160] This did not change until President Ronald Reagan signed the Tax Reform Act of 1986 (TRA 86). The general goal of TRA 86 was to simplify the tax code, eliminate numerous

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159 See Getsinger, L., Lim, K., Toder, E., & Turner, M. A. (2010, May 26). Reforming the Mortgage Interest Deduction. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/uploadedpdf/412099-mortgage-deduction-reform.pdf on page 1.
160 Id.

tax shelters and reduce individual tax rates.[161] As a result, the number of tax brackets were reduced from 15 to 2, and the highest marginal tax rate was reduced from 50% to 28%.[162] TRA 86 also ended the deductibility of all forms of interest payments with certain exceptions made for investment interest and "qualified residence interest," or mortgage interest.[163] The mortgage interest deduction was retained to encourage Americans to work towards home ownership.[164] President Reagan explained "I want you to know that we will preserve the part of the American dream which the home-mortgage-interest-deduction symbolizes."[165]

The Home Mortgage Interest Deduction (MID) is currently one of the largest tax expenditures in the federal income tax system, costing approximately $72 billion in 2011. The MID can be found today in §163(h)(3) of the Internal Revenue Code (IRC) as "qualified residence interest," uniquely existing as an exception to an exception of a tax law. "Qualified residence" is defined as the "principal residence", or the main home, plus one secondary home that the taxpayer owns.[166] There are currently two categories of mortgage debt that produce qualified residence interest. The first is known as "acquisition indebtedness" or "first mortgage," which is debt incurred in "acquiring, constructing or substantially improving any qualified

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161 For more information, see PL 99-514 Tax Reform Act of 1986. 26 U.S.C. 1 et seq. 100 Stat. 2085.

162 See The Tax Foundation (2013, December 9). *Fed U.S. Federal Individual Income Tax Rates History, 1862-2013*. [Table] Retrieved from http://www.scribd.com/doc/190499803/Fed-U-S-Federal-Individual-Income-Tax-Rates-History-1862-2013. Note the change from 1986 to 1988.

163 PL 99-514 Tax Reform Act of 1986, §511, 100 Stat. 2085.

164 There is also speculation that because homeowners tend to be more engaged in local politics and community building, there may be other political motivations to subsidizing home ownership. This will not be covered in this thesis. For more information, see: Getsinger, L., Lim, K., Toder, E., & Turner, M. A. (2010, May 26). Reforming the Mortgage Interest Deduction. *Tax Policy Center.* Retrieved from http://www.taxpolicycenter.org/uploadedpdf/412099-mortgage-deduction-reform.pdf on pages 2-3.

165 See Lowenstein, R. (2006, March 5). Who Needs the Mortgage-Interest Deduction? *The New York Times.* Retrieved from http://www.nytimes.com/2006/03/05/magazine/305deduction.1.html?pagewanted=1&_r=3& on page 3.

166 §163(h)(4)(A) If more than one secondary home is owned, the taxpayer can choose which home to claim as the second residence.

residence of the taxpayer" that is "secured by such residence."[167] Debt used to purchase, build or renovate a home would be considered acquisition debt. The second is "home equity indebtedness" or "second mortgage," which can be any debt other than acquisition debt that is secured by a qualified residence as long as it is not more than the fair market value of the residence reduced by the acquisition debt (known as the equity in the home).[168] For example, if the fair market value of a qualified residence is $200,000 and acquisition debt on that residence is $150,000, up to $50,000 of home equity debt can be secured by that residence. If the taxpayer has more than $50,000 of home equity debt, then only $50,000 of it will be considered for the MID. Home equity debt does not necessarily have to be used for the home. There is a limit to the debt that can be used in computing MID, however. The amount of acquisition debt allowed is limited to $1,000,000, while home equity debt is limited to $100,000.[169] The interest that is paid on the allowed debt is deducted on the individual federal income tax return under Itemized Deductions.[170]

The MID has been the subject of numerous negative responses from the public for two main reasons. Firstly, the MID disproportionately benefits the wealthy over typical taxpayers, to the point that some brand it as a tax loophole.[171] While the majority of claims for the MID come from middle- and lower-income families,[172] higher-income families experience larger and more frequent benefits. This in part stems from the MID's status as an itemized deduction. Taxpayers

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167 §163(h)(3)(B)
168 §163(h)(3)(C)
169 §163(h)(3)
170 See Internal Revenue Service. (2013). *Schedule A (Form 1040): Itemized Deductions.* Retrieved from http://www.irs.gov/pub/irs-pdf/f1040sa.pdf
171 For an example, see Bell, K. (2012, December 17). Tax loopholes that mainly benefit the rich. *Bankrate.com.* Retrieved from http://www.bankrate.com/finance/taxes/tax-loopholes-mainly-benefit-rich-1.aspx
172 DeZube, D. (2011, February 11). 6 Mortgage Interest Deduction Myths. *National Association of Realtors.* Retrieved from http://www.houselogic.com/home-advice/mortgage-interest-deduction/mortgage-interest-deductions/

with lower incomes typically experience little to no tax benefit from itemizing deductions as opposed to taking the standard deduction. As a result, the MID disproportionately benefits taxpayers with higher incomes. In 2003, only 4% of taxpayers with incomes under $20,000 claimed the MID, while 75.7% of taxpayers with incomes over $200,000 claimed the MID.[173] This trend continued in 2010, where 1.1% of taxpayers with incomes under $20,000 claimed the MID, while 76.8% of taxpayers with incomes over $200,000 claimed the MID.[174]

Wealthier taxpayers often own more expensive homes and thus also receive a larger deduction. In 2012, taxpayers with incomes over $200,000 received tax savings of $6,370 on average from the MID, while taxpayers with incomes between $10,000 and $20,000 received only $321 on average.[175] Tax deductions also save wealthier taxpayers more money dollar-for-dollar because the wealthy experience higher tax rates. For example, a taxpayer in the 39.6% marginal tax bracket would theoretically save $3,960 on $10,000 of interest debt, while a taxpayer in the 15% tax bracket would only save $1,500 on the same amount. Therefore, the wealthy benefit more from the MID by proportion as well as by raw dollar amount.

The second reason contributing to the MID's infamy is its lack of effect on home ownership, which causes experts to question whether the MID actually fulfills its purpose. Some note that only higher-income taxpayers can itemize deductions, but most of them would own a home regardless of the benefit from the MID.[176] Likewise, lower-income taxpayers that only

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173 See Prante, G. (2006, February 6). Who Benefits from the Mortgage Interest Deduction?. *The Tax Foundation.* Retrieved from http://taxfoundation.org/article/who-benefits-home-mortgage-interest-deduction

174 See Horpedahl, J. (2013, January 8). The Home Mortgage Interest Deduction. *Mercatus Center: George Mason University.* Retrieved from http://mercatus.org/publication/home-mortgage-interest-deduction

175 See Black, R., Cramer, R. & King, J. (2012, April 11). The Assets Report 2012. *New America Foundation.* Retrieved from http://www.newamerica.net/publications/policy/the_assets_report_2012

176 See Lowenstein, R. (2006, March 5). Who Needs the Mortgage-Interest Deduction? *The New York Times.* Retrieved from http://www.nytimes.com/2006/03/05/magazine/305deduction.1.html?pagewanted=1&_r=3& on page 4.

have the money to rent would still do so regardless of the MID.[177] Supporters of this argument point out that home ownership rates in the United States are "about the same as it is in Canada, Australia and England, where interest isn't deductible."[178] However, since the existence of the MID after TRA 86, itemization rates have fluctuated up and down significantly while home ownership remains between 63 and 68 percent.[179] This suggests that the MID has little (if any) influence on home ownership rates. What has been affected is the amount of mortgage debt in the United States. Since the enactment of TRA 86, the amount of total outstanding mortgage debt as a percent of GDP has risen from approximately 40% in 1986, to eventually nearly 80% before finally falling after the mortgage crisis in 2008.[180]

Despite the criticisms the MID receives, it should not be misconstrued as a loophole. All of the MID's flaws are the inherent flaws that all tax expenditures exhibit. As mentioned in Chapter 1, tax expenditures are an inefficient form of spending, and many of them disproportionately benefit higher-income taxpayers. Because the MID would reward taxpayers for purchasing homes they would have bought anyway, it is inherently inefficient at increasing home ownership. Tax expenditures also tend to benefit the wealthy more than the typical taxpayer, simply because the wealthy have more resources.

This does not necessarily mean that are no ways to use the MID as a loophole. One

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177 See Brown, D. A. (2010, December 3). End the unfair tax break for homeowners. *CNN Opinion*. Retrieved from http://www.cnn.com/2010/OPINION/12/02/brown.repeal.homeowner.break/index.html. The author believes that the MID penalizes people for personal life choices such as renting.

178 See Lowenstein, R. (2006, March 5). Who Needs the Mortgage-Interest Deduction? *The New York Times*. Retrieved from http://www.nytimes.com/2006/03/05/magazine/305deduction.1.html?pagewanted=1&_r=3& on page 3.

179 See Glaeser, E. L. & Shapiro, J.M. (2002, October). THE BENEFITS OF THE HOME MORTGAGE INTEREST DEDUCTION. *Tax Policy and the Economy*, vol.17. Cambridge, MA: National Bureau of Research. Retrieved from http://www.nber.org/papers/w9284.pdf

180 See Frederick, D. (2013, August 7). Reconciling Intentions with Outcomes: A Critical Examination of the Mortgage Interest Deduction. *Akron Tax Journal*, Article 2. Retrieved from https://www.uakron.edu/dotAsset/15cebb2d-a726-4eb8-83fb-404ce77a70c4.pdf on page 68.

example is the use of a luxury boat, such as a yacht, as a second home for the MID.[181] While these are not considered secondary homes traditionally, they can qualify as such under IRS regulations. According to the IRS, a home has sleeping, cooking and toilet facilities,[182] and is used for personal purposes by the taxpayer for at least 14 days.[183] The definition is worded this way to include boat homes that might only have a temporary toilet and camp stove, but can also include luxury boats typically used for extravagant enjoyment rather than living space. Another example of a loophole is when mortgage debt is used to finance a home when it is clearly not needed. For example, known multi-billionaire and CEO of Facebook Mark Zuckerberg[184] "refinanced the $5.9 million mortgage on his house to a 30-year adjustable loan with an introductory rate of 1.05 percent."[185] Although Zuckerberg certainly has the ability to pay for the house with pure cash, he financed it with a low mortgage rate so that he could deduct the mortgage interest under the MID. What makes this controversial is the fact that Zuckerberg is essentially using government funds to pay for something he could clearly pay for himself.

The inherent flaws of the MID, as well as the loopholes exploiting it, have led many experts to suggest methods of tax reform. These methods of reform can classified into two general categories. The first category includes reforms that seek to either scale back home subsidization, or end it completely. These reforms range from placing general caps on the MID,

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181 An example of this is Kent Webb, a North Carolina physician owning a luxury fishing boat who currently opposes the removal of the second home deduction. He is quoted here: McCormick, J. (2014, January 23). Yacht Owners Seek to Salvage Deduction for Second Homes. *Bloomberg.* Retrieved from http://www.bloomberg.com/news/2014-01-23/yacht-owners-seek-to-salvage-deduction-for-second-homes.html

182 See Internal Revenue Service. (2013). *Publication 936: Home Mortgage Interest Deduction.* Retrieved from http://www.irs.gov/publications/p936/ar02.html

183 §280A(d)(1)

184 See The World's Billionaires. (2014, March). *Forbes.* Retrieved from http://www.forbes.com/profile/mark-zuckerberg/

185 See Yglesias, M. How the Tax Code Subsidizes Millionaires' Mansions. (2012, July 16). *Slate.* Retrieved from http://www.slate.com/blogs/moneybox/2012/07/16/how_the_tax_code_subsidizes_millionaires_mansions.html

to eliminating specific groups from the MID, such as the Ending Taxpayer Subsidies for Yachts Act.[186] For reforms in this category, the federal government would need to decide whether to keep the resulting increased tax revenue or decrease general income tax rates to compensate taxpayers for the lost deduction.[187] Some experts fear that this method would hurt the U.S. housing market,[188] which had recently recovered from the subprime mortgage crisis of 2008. There is also another reform solution discussed at the end of this chapter, which caps total itemized deductions for highest income taxpayers. This would also naturally affect the amount of MID that wealthy taxpayers can claim.

The second category includes reforms that create more equitable tax treatment. One suggestion is to convert the MID into a tax credit, so that even taxpayers who do not itemize can benefit from it.[189] Some suggest the implementation of a renters' tax credit, to provide renters with the same tax benefits as home owners.[190]

The MID has multiple flaws that continue to attract negative attention from the public. These flaws, however, have not been corrected because of the intense lobbying from the real estate industry, citing potential risks to the housing market. Because these flaws are common characteristics of tax expenditures, they were almost definitely foreseen before the MID's enactment. Because tax loopholes are unforeseen, or unintended flaws, the MID's main flaws are

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186 See H.R. 2563--113th Congress: Ending Taxpayer Subsidies for Yachts Act. (2013). *GovTrack.us* Retrieved from https://www.govtrack.us/congress/bills/113/hr2563.

187 This is mentioned in: Horpedahl, J. (2013, January 8). The Home Mortgage Interest Deduction. *Mercatus Center: George Mason University.* Retrieved from http://mercatus.org/publication/home-mortgage-interest-deduction

188 See Fischer, W. & Huang, C. (2013, June 25). Mortgage Interest Deduction Is Ripe for Reform; Conversion to Tax Credit Could Raise Revenue and Make Subsidy More Effective and Fairer. *Center on Budget and Policy Priorities.* Retrieved from http://www.cbpp.org/files/4-4-13hous.pdf. on page 1.

189 Id. on page 6.

190 See Fischer, W. & Sard, B. (2013, August 21). Renters' Tax Credit Would Promote Equity and Advance Balanced Housing Policy. *Center on Budget and Policy Priorities.* Retrieved from http://www.cbpp.org/files/7-13-12hous.pdf.

not loopholes. While the MID might not be fulfilling its original purpose of increasing home ownership rates, it receives the majority of claims from the middle-class, as intended. The MID may not be a tax loophole, but it is certainly far from being a perfect tax expenditure.

***The Preferential Capital Gains Tax***

The taxation of capital gains is a frequently debated political issue that continues to influence tax policy and presidential elections. Capital gains are the profits earned from the sale of capital assets,[191] defined in the IRC as almost any property held for personal or investment purposes.[192] Examples of capital assets include real estate, valuables, stocks and bonds. The IRS requires taxpayers to report capital gains when these assets are sold, so that they can be properly taxed on their individual income tax returns.[193] Income from capital gains is distinct from ordinary income and thus, is taxed differently. Because each taxpayer can receive different amounts of capital income, fairness is often questioned when juxtaposing taxpayers with differing sources of income.

Capital gains have a long history in the tax code, being taxed since the ratification of the 16th Amendment to the U.S. Constitution in 1913.[194] They were originally taxed at ordinary income rates, but experienced numerous changes throughout the years.[195] Early on, the tax code favored capital gains, creating the separate tax rate for capital gains on assets held long-term (then defined as exceeding two years) after 1922, and an allowed exclusion for a portion of

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191 See Internal Revenue Service. (2011, February 18). Ten Important Facts About Capital Gains and Losses. *IRS Tax Tip 2011-35*. Retrieved from http://www.irs.gov/uac/Ten-Important-Facts-About-Capital-Gains-and-Losses

192 §1221

193 See Internal Revenue Service. (2011, February 18). Ten Important Facts About Capital Gains and Losses. *IRS Tax Tip 2011-35*. Retrieved from http://www.irs.gov/uac/Ten-Important-Facts-About-Capital-Gains-and-Losses

194 See Auten, G. (1999, October 1). Capital gains taxation. *Urban Institute.* Retrieved from http://www.urban.org/UploadedPDF/1000519.pdf on page 58.

195 Id.

capital gains after 1934.[196] Then, capital gains saw greater taxation when capital gains tax rates were increased in 1969 and 1976.[197] Capital gains taxation finally began to settle in today's form after the Tax Reform Act of 1986,[198] which removed capital gains exclusion, and the Taxpayer Relief Act of 1997,[199] which reduced the top marginal capital gains rates. Long-term capital gains rates were reduced to the rate of 15 percent seen today by Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).[200] JGTRRA also created the same preferential rate for qualified dividends, which had previously been taxed as ordinary income. Qualified dividends are basically dividends on the stock of U.S. corporations, as long as the taxpayer has owned the stock for at least 60 days. Currently, the tax code favors long-term capital gainsover ordinary income, as those with capital gains income enjoy a lower, preferential tax rate.[201] Long-term capital gains are gains from the sale of capital assets held more than one year. If the capital asset is held one year or less, then it is a short-term capital gain and receives no preferential treatment. In essence, it is taxed like interest income. The preferential rate is justified by supporters as an incentive for investment and, as a result, long-term economic growth.[202] Today, it is considered one of the largest federal income tax expenditures in the United States. The Congressional Budget Office (CBO) has estimated that it will cost an average of almost $100 billion per year

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196 Id.

197 Id.

198 PL 99-514 Tax Reform Act of 1986 §301, 100 Stat. 2086

199 PL 105-34 Taxpayer Relief Act of 1997 §311, 111 Stat. 832

200 PL 108-27 Jobs and Growth Tax Relief Reconciliation Act of 2003 §301, 117 Stat. 752. This Act, known as one of the “Bush Tax Cuts” continues to be the subject of public scrutiny today.

201 See Huang, C. & Marr, C. (2012, September 19). Raising Today's Low Capital Gains Tax Rates Could Promote Economic Efficiency and Fairness, While Helping Reduce Deficits. *Center on Budget Policy and Priorities.* Retrieved from http://www.cbpp.org/files/9-19-12tax.pdf on page 1.

202 See The Committee for a Responsible Federal Budget. (2013, August 27). The Tax Break-Down: Preferential Rates on Capital Gains. *The Tax Break-Down, Article 3* Retrieved from http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains

from 2013 to 2017.[203]

Supporters of the preferential capital gains rate do not dispute the fact that it has flaws, but they argue that the preferential rate is needed to mitigate some of the distortions caused by the federal income tax system. One frequently referenced example is inflation. Capital gains are not adjusted for inflation, meaning that taxpayers pay capital gains tax for gains in value attributed to inflation, even when the relative value of the asset itself has not increased.[204] The low rate is also beneficial to the elderly, who are likely to accumulate multiple assets throughout their lifetimes. Taxpayers over the age of 65 are 2.5 times more likely to realize capital gains in any given year than taxpayers under the age of 65.[205] The low rate also compensates for what is known as the "lock-in effect." Because capital gains are only taxed upon the *sale* of a capital asset, taxpayers may hold onto assets they otherwise would have sold, in order to defer taxation.[206] Some investors have found creative ways to circumvent the "lock-in effect" such as the use of capital assets to secure a loan.[207] This essentially allows them to earn a cash profit from their asset and pay interest instead of capital gains taxes. The "lock-in effect" is estimated to be strong enough that raising the capital gains rates would actually reduce tax revenue in the short-term.[208]

Opponents would argue that the benefits of preferential capital gains are overstated, or that the aforementioned distortions have no real effect on capital asset sales. Their

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203 Id.

204 See Moore, S. (2007, December). Capital Gains Taxes. *The Concise Encyclopedia of Economics.* Retrieved from http://www.econlib.org/library/Enc/CapitalGainsTaxes.html

205 Id.

206 Id.

207 See Auten, G. (1999, October 1). Capital gains taxation. *Urban Institute.* Retrieved from http://www.urban.org/UploadedPDF/1000519.pdf on page 58.

208 See Viard, A. D. (2012, June 12). The capital gains preference: Imperfect, but useful. *American Enterprise Institute.* Retrieved from http://www.aei.org/article/economics/fiscal-policy/taxes/the-capital-gains-preference-imperfect-but-useful/

counterargument against inflation is that taxpayers can defer taxation by simply waiting for a more opportune moment to sell their assets.[209] Therefore, inflation's effect on capital gains sales should never be significant enough to warrant a tax expenditure; the benefit of deferring taxation at will compensates for it. The elderly, despite being more likely to have capital income, are typically affected very little by the preferential capital gains rate. The preferential rates due to capital gains and dividends combined are worth less than $6 per year on average to elderly households.[210] As for the "lock-in effect," some experts have posited that the source of the effect is instead the tax provision for capital gains forgiveness on death.[211] When a taxpayer keeps a capital asset until death, the taxpayer's estate or heirs only pay capital gains tax on the appreciation since the decedent taxpayer's death if they sell the asset afterward.[212] Therefore, there is an incentive to hold on to assets for very long periods of time, waiting either for high gains, a tax rate reduction, or death.

Both sides of the argument usually agree that the preferential rate has the same two flaws as the Home Mortgage Interest Deduction. Firstly, it disproportionally favors higher-income taxpayers because they own vastly more capital assets and subsequently earn more capital income. In 2013, 75.9% of all of the tax benefits provided by capital gains were received by taxpayers with incomes over $1 million.[213] By comparison, taxpayers with incomes between $500,000 and $1 million only received 9.8% of the tax benefits, while income groups below

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209 See Huang, C. & Marr, C. (2012, September 19). Raising Today's Low Capital Gains Tax Rates Could Promote Economic Efficiency and Fairness, While Helping Reduce Deficits. *Center on Budget Policy and Priorities.* Retrieved from http://www.cbpp.org/files/9-19-12tax.pdf on page 4.

210 Id. on page 3.

211 Id. on page 20.

212 §1031(f)(2)(A)

213 See The Committee for a Responsible Federal Budget. (2013, August 27). The Tax Break-Down: Preferential Rates on Capital Gains. *The Tax Break-Down, Article 3* Retrieved from http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains

$100,000 barely received 1.4% of the benefits in total.[214] The high concentration of tax benefits in the top income groups demonstrates that the majority of capital assets are owned and sold by the wealthy. This results in a lower effective tax rate for the wealthy, since taxpayers with a higher proportion of capital gains and dividend income effectively have a lower tax rate overall.[215] A taxpayer in the 33% tax bracket, for example, would theoretically have a tax rate of 15% if the only source of income earned that year was long-term capital gains and qualified dividends. That same taxpayer would be taxed at 33% if only ordinary income was earned instead.

The preferential capital gains rate is also criticized for its effect, or lack of effect (depending on one's perspective) on investment and on the economy. This is a topic that is also debated by experts because of its potential effect on tax policy. Preferential rate supporters have provided data demonstrating that capital gains tax revenue increases whenever the capital gains rate is reduced to 20% or lower.[216] However, opponents contend that taxpayers purposely wait for the capital gains rate to decrease before selling their capital assets.[217] This could be attributed to the "lock-in effect," which would explain the large spikes in revenue after capital gains rate decreases, which rapidly returned to normal revenue levels shortly after.[218] Opponents have provided data demonstrating that the capital gains rate has no statistically significant affect on

214 Id.

215 This effect is discussed in: Huang, C. & Marr, C. (2012, September 19). Raising Today's Low Capital Gains Rates Could Promote Economic Efficiency and Fairness, While Still Helping Reduce Deficits. *Center on Budget and Policy Priorities.* Retrieved from http://www.cbpp.org/files/9-19-12tax.pdf on page 10.

216 See Moore, S. *Capital Gains Tax and Revenue Raised.* [Graph]. Retrieved from http://www.econlib.org/library/Enc/art/lfHendersonCEE2_figure_004.jpg

217 See Moore, S. (2007, December). Capital Gains Taxes. *The Concise Encyclopedia of Economics.* Retrieved from http://www.econlib.org/library/Enc/CapitalGainsTaxes.html

218 This effect is most noticeable after 1986 following TRA 86 and after 2001 following EGTRRA of 2001, both of which reduced the capital gains rate significantly. See Moore, S. *Capital Gains Tax and Revenue Raised.* [Graph]. Retrieved from http://www.econlib.org/library/Enc/art/lfHendersonCEE2_figure_004.jpg

real GDP,[219] or on stock prices,[220] supporting their argument that the preferential rate does not create long-term economic growth. In addition, nearly half of all capital gains are never subject to tax because of capital gains forgiveness on death,[221] further proving the "lock-in effect." Opponents also point out the existence of the carried interest loophole discussed in Chapter 2, which makes use of the preferential rate to provide tax benefits which would otherwise be undeserved.

Experts on both sides of the capital gains debate have offered different methods of reform for either improving or removing parts of the tax expenditure. One extreme suggestion is to remove the preferential rate entirely, taxing all capital gains as ordinary income.[222] This method is not widely agreed upon because of how it is estimated to lose revenue to the "lock-in effect." More agreeable reform suggestions account for the effect by either including a capital gains exclusion of 30% or capping capital gains tax at 28%.[223] Either option would theoretically generate tax revenue between $50 and $100 billion between 2014 and 2023 while taxing capital gains as ordinary income.[224] Other methods of reform target specific areas, either by removing loopholes such as carried interest, or by removing the "lock-in effect" through revising capital gains forgiveness on death.[225] As of the time of writing, none of these approaches have been attempted.

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219 See Huang, C. & Marr, C. (2012, September 19). Raising Today's Low Capital Gains Rates Could Promote Economic Efficiency and Fairness, While Still Helping Reduce Deficits. *Center on Budget and Policy Priorities.* Retrieved from http://www.cbpp.org/files/9-19-12tax.pdf on page 12.

220 Id. on page 13.

221 Id. on page 24.

222 See The Committee for a Responsible Federal Budget. (2013, August 27). The Tax Break-Down: Preferential Rates on Capital Gains. *The Tax Break-Down, Article 3* Retrieved from http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains. Some more extreme suggestions include moving the entire tax code toward a consumption tax, and raising tax rates up to 45 percent.

223 Id.

224 Id.

225 Id.

Preferential capital gains taxation is an issue that has always been, and will likely continue to be heavily disputed. While the preferential rate does not appear to create economic growth, removing it would likely hurt capital gains transactions and subsequently government tax revenue short-term. This does not mean that capital gains will never see changes in the future, but it does make tax reform more complicated. Because of how frequently and drastically capital gains taxation has changed in the past, it is difficult to predict for certain what the long-term effects of any particular policy would be. The lack of long-term predictability compounded with the current government deficits are likely to encourage short-term thinking in terms of reform. As such, preferential capital gains taxation will most likely remain in existence indefinitely. Any reforms it experiences in the future will likely take a more cautious approach to preserve government tax revenue, such as small rate increases. Indeed new tax legislation in December 2012 implemented a new 20 percent rate on long-term capital gains and dividends for taxpayers in the highest tax bracket, the 39.6 percent tax bracket with this legislation.[226] As of this writing it is too early to determine the economic effects of this legislation, as the rates became effective only for tax years beginning in 2013.

***Charitable Contributions***

The charitable contributions deduction, found today in §170 of the IRC, is an old tax expenditure that encourages taxpayers to donate to charitable organizations. It is an itemized deduction, rewarding taxpayers with a reduced tax liability based on the fair market value of cash and property (but not services) donated if they itemize. Similar to the MID, charitable contributions can only be deducted if taxpayers itemize. This means that like the MID, the charitable contributions deduction tends to favor higher income taxpayers, as the vast majority of

226 American Taxpayer Relief Act of 2012 (Public Law 112-240), Section 102.

lower and middle income taxpayers will claim the standard deduction.

Only donations to qualified organizations are allowed for the tax deduction. According to the IRS, these include organizations that operate for the purposes of charity, religion, science, education, or war veterans' support, and many others.[227] The IRS also requires taxpayers to keep written records of the date, amount and recipient of the donation, as proof of its occurrence.[228] It is believed that charities are better at delivering social services than the government; the charitable contribution deduction's purpose is to allow the public, rather than the government, to choose which charities to support.[229] However, the tax deduction currently draws negative attention from the fact that wealthy taxpayers can donate millions of dollars to greatly reduce their tax liability.

The charitable contribution deduction has existed in the tax code since the enactment of the War Income Tax Revenue Act of 1917.[230] It included a provision for a ceiling, or limit, on the deduction rewarded equal to 15% of the taxpayer's taxable net income.[231] This ceiling was enacted to prevent taxpayers from abusing it to completely eliminate their taxable income. It was later revised by the Individual Income Tax Act of 1944, where the measurement of the ceiling was changed from “net taxable income” to “adjusted gross income” (AGI).[232] Adjusted gross income (AGI) is basically the taxpayer's taxable income before itemized deductions (or the

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227 Internal Revenue Service. (2013). *Publication 526: Charitable Contributions.* Retrieved from http://www.irs.gov/publications/p526/ar02.html#en_US_2013_publink1000229641

228 Internal Revenue Service. (2013, December 12). *Topic 506: Charitable Contributions.* Retrieved from http://www.irs.gov/taxtopics/tc506.html

229 See Joint Committee on Taxation. (2013, February 11). *Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions*, JCX-4-13. Retrieved from https://www.jct.gov/publications.html?func=startdown&id=4506 on page 4.

230 See Lindsey, V. W. (2003, January 1). The Charitable Contributions Deduction: A Historical Review and a Look to the Future. *Marquette Law Scholarly Commons.* Paper 573. Retrieved from http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=1574&context=facpub on page 1061.

231 Id. on page 1061.

232 Id. on page 1062.

standard deduction if higher) and any deduction for personal and dependency exemptions.

Because AGI can be higher than net taxable income, taxpayers were typically allowed a higher deduction. Congress continued increasing the allowed charitable contributions deduction over the following years. The ceiling steadily rose to 20% of AGI in 1952, then 30% in 1954, and was even removed in 1964 for taxpayers who contributed more than 90% of their taxable income.[233] The definitions for qualifying organizations as well as qualifying donations also broadened over time,[234] partly due to changes in technology (computers could now be donated), but ultimately to further encourage charitable donations.

The charitable contributions deduction eventually settled into today's form after its abuse by wealthy taxpayers prompted members of Congress to enact reforms. The unlimited tax ceiling of 1964 was eventually lowered to a ceiling of 50% by 1974,[235] which currently applies to all taxpayers today. Other abuses of the system were addressed by the Tax Reform Act of 1969, which prevented a potential loophole involving preferred stock in *Bialo v. Commissioner*,[236] and reduced the deduction for property experiencing capital gains.[237] To continue charitable support, a five-year carryover period was implemented for individuals by the Deficit Reduction Act of 1984,[238] allowing them to "carry" deductions that exceeded the ceiling into future tax years (known as a carryforward) until they were used or the carryover period

233 Id. on page 1064.
234 Id. on pp. 1064-1070.
235 Id. on page 1065.
236 This is a complicated court case involving a taxpayer who contributed preferred stock to a trust fund and then redeemed it back to supposedly prevent the takeover of his private corporation, while continuing to take the charitable contributions deduction. The Tax Court later rejected Bialo's arguments. For more information, see: Walter Bialo and Mildred Bialo v. Commissioner of Internal Revenue. (1987). 88 T.C. 1132
237 See Lindsey, V. W. (2003, January 1). The Charitable Contributions Deduction: A Historical Review and a Look to the Future. *Marquette Law Scholarly Commons.* Paper 573. Retrieved from http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=1574&context=facpub on page 1061.
238 Id. on page 1069.

expired. As long as actual charitable donations in the carryforward years, plus the amounts carried forward, do not exceed 50% of AGI, the carryforward contributions can eventually be deducted. This means that taxpayers who carefully plan their donations can deduct 50% of their AGI in any five-year period. Today, the tax deduction is another one of the largest tax expenditures in the tax code; its elimination would theoretically increase tax revenues by $39 billion.[239] It also includes numerous provisions with special rules for certain types of contributions, which are beyond the scope of this thesis.[240]

The charitable contributions deduction is essentially a government subsidy where the public gets to decide where the funds go. One issue with this is that not everyone will agree with where the public chooses to place their donations, or how recipients use the donations. Currently, tax-qualified donations are received by organizations relating to religion, education, human services, health, the arts, and environment and animal welfare.[241] The majority of donations are received by religious organizations,[242] which devote most of their budget (approximately 77%) towards salaries, buildings, utilities and administration.[243] These spending items are primarily used for the purpose of worship, which does not serve the public at large or provide assistance to third-world countries. As a result, some argue that churches are not efficiently serving the original purpose of the tax deduction.[244] This criticism applies to some

239 See Entin, S. J. & Schuyler, M. (2013, August 9). Case Study #11: Deduction for Charitable Contributions. *Tax Foundation.* Retrieved from http://taxfoundation.org/article/case-study-11-deduction-charitable-contributions

240 §170

241 See Giving USA Foundation. (2010). *US Tax-qualified Giving in 2010, Percent of Total.* [Chart]. Retrieved from http://www.economonitor.com/dolanecon/files/2012/04/P120419-1.png

242 Id.

243 See Christianity Today. *Breakdown of Church Expenditures by Category.* [Chart]. Retrieved from http://www.economonitor.com/dolanecon/files/2012/04/P120419-2.png

244 See Dolan, E. (2012, April 20). The Charitable Deduction as a Tax Expenditure: What it Buys and What to Do About It (Part 1). *EconoMonitor.* Retrieved from http://www.economonitor.com/dolanecon/2012/04/20/the-

extent to other organizations as well, because their resources can never fully be spent on public service. Unfortunately, it is impossible for charitable contributions deduction to be completely efficient because of how it is designed. For the charitable contributions deduction to be *perfectly* efficient, taxpayers would have to only donate to organizations that serve the public. But because qualified charitable organizations will not always focus on charitable activities, and organizations that partake in charitable activities will not necessarily be qualified, the tax deduction is inefficient for public service. It is also economically inefficient, because a large amount of charitable donations would still be made regardless of the deduction[245] (although others argue that the deduction increases the amount that taxpayers donate).[246]

The deduction also continues to disproportionately benefit the wealthy similarly to the Home Mortgage Interest Deduction (MID), despite past reforms attempting to address this effect. Since richer taxpayers have a higher AGI in addition to more valuable itemized deductions and donations, they are vastly more likely to benefit from charitable contributions than most taxpayers. Like the MID, the higher the tax bracket is for an individual, the larger the tax benefit the deduction provides. As such, taxpayers in the 39.6% tax bracket would reduce their tax liability by $3,960 for $10,000 of charitable deductions while taxpayers in the 15% tax bracket would only reduce their tax liability by $1,500 despite donating the same amount. Recent tax legislation discussed later in this chapter attempts to address this issue.

In 2011, 85.2% of the total dollar amount of tax benefits attributed to charitable

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charitable-deduction-as-a-tax-expenditure-what-it-buys-and-what-to-do-about-it-part-1/

245 See Congressional Budget Office. (2013, November 13). Retrieved from http://www.cbo.gov/budget-options/2013/44800

246 See Feldstein, M. (2009, March 25). An Anti-Charity Tax, at the Worst Time. *The Washington Post.* Retrieved from http://www.washingtonpost.com/wp-dyn/content/article/2009/03/24/AR2009032402462.html

contributions that year was received by taxpayers with incomes higher than $100,000.[247] In addition, the average dollar amount of benefit received by each income group appears to increase exponentially with each higher income group. Taxpayers with incomes between $10,000 and $20,000 in 2011 received $1 of tax savings (benefits) on average, while those with incomes between $75,000 and $100,000 received $206, and those with incomes higher than $1 million received $24,876.[248] These tax benefits are due not only to wealthier taxpayers contributing larger amounts but also to their being in higher tax brackets, as explained above.

The wealthiest taxpayers receive enough benefits from the charitable contributions deduction that they can reduce their tax liability by millions. Examples of this have been demonstrated frequently by celebrities and politicians. Mitt Romney and Barack Obama have both been criticized for their use of the deduction, despite their seemingly contradictory approach to reform.[249] [250] Warren Buffett saves "around $3.3 million of federal income taxes each year" from charitable contributions alone.[251] This is expected to increase dramatically, as both Buffett and Bill Gates have pledged with other billionaires to donate half of their net worth to charity.[252] While there may not seem to be anything unethical about this decision, their potential tax benefits have caused some experts to approach it with skepticism.

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247 See Tax Policy Center. (2011, August 10). *Table T11-0252 – Tax Expenditure Benefits; Charitable Contributions Deduction; Baseline: Current Law; Distribution by Cash Income Level, 2011*. [Table]. Retrieved from http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3134&DocTypeID=1

248 Id.

249 For Mitt Romney, see: Drucker, J. (2012, October 29). Romney Avoids Taxes via Loophole Cutting Mormon Donations. *Bloomberg.* Retrieved from http://www.bloomberg.com/news/2012-10-29/romney-avoids-taxes-via-loophole-cutting-mormon-donations.html

250 For Barack Obama, see: Lederman, J. (2013, April 15). 'Charity Loophole' Lowers Obama's Effective Tax Rate to 18.4%. *CNSNews.com.* Retrieved from http://cnsnews.com/news/article/charity-loophole-lowers-obamas-effective-tax-rate-184

251 See Green, R. A. (2011, August 17). How Warren Buffett Saves Billions On His Tax Return. *Forbes.* Retrieved from http://www.forbes.com/sites/greatspeculations/2011/08/17/how-buffett-saves-billions-on-his-tax-return/

252 Id.

A number of reforms have been suggested to make the charitable contributions deduction more equitable. The entire removal of the deduction has been suggested by some, but has not been widely accepted because of the potential harm to charitable organizations. However, many experts have considered implementing a cap on the deduction for higher-income taxpayers.[253] President Obama's budget proposal for fiscal year 2015 included a 28% cap for all deductions for taxpayers within the top 3 percent of incomes.[254] Nonprofit organizations have criticized the cap, estimating that its enactment could cause donations to decline by more than $9.4 billion per year.[255] Other suggestions for reform include turning the deduction into a tax credit for those who do not itemize, creating a phase-out process that would gradually give less of a deduction as more is donated, and hybrids of multiple reform approaches.[256] In addition, if the deduction is turned into a tax credit, there are ways to customize it such as adding a floor or making it nonrefundable in order to balance revenue with tax equity.

The charitable contributions deduction is a tax issue that surprisingly appears to have bipartisan consensus over its flaws. It can be predicted that the deduction will continue to experience reforms as it has in the past, perhaps beginning with President Obama's proposed 28% cap in 2015. Its complete removal—at least in the near future—is highly unlikely because of its effects on nonprofit organizations. However, its negative reputation for supporting the rich

253 See Committee for a Responsible Federal Budget. (2012, November 16). Softening the Blow on the Charitable Deduction. *Tax Expenditures.* Retrieved from http://crfb.org/blogs/softening-blow-charitable-deduction

254 See Daniels, A. (2014, March 4). Obama 2015 Budget Would Cap Charitable Deduction at 28% for Wealthy. *The Chronicle of Philanthropy.* Retrieved from http://philanthropy.com/article/Obama-2015-Budget-Would-Cap/145099/

255 See The Charitable Giving Coalition (2014). 28% Cap on Charitable Deductions in Administration Budget Would Cause Donations to Decline by More Than $9.4 Billion/Year. Retrieved from http://protectgiving.org/release/28-cap-on-charitable-deductions-in-administration-budget-would-cause-donations-to-decline-by-more-than-9-4-billionyear/

256 See Committee for a Responsible Federal Budget. (2012, November 16). Softening the Blow on the Charitable Deduction. *Tax Expenditures.* Retrieved from http://crfb.org/blogs/softening-blow-charitable-deduction

will ensure its future revision. One complex approach was implemented with 2012 legislation discussed below.

***The 2012 Tax Act and the Phase-Out of the MID and Charitable Contributions***

One reform aimed at reducing the benefits to the highest income taxpayers is to eliminate as much as 80% of their total itemized deductions, including the MID and charitable contributions, with no carryforward of any lost deduction.[257] This reform is aimed at the top 1% of income-earners, the richest individuals like Warren Buffett, Bill Gates and Mark Zuckerberg. Itemized deductions through this reform are reduced, or "phased-out," as the taxpayer's AGI surpasses the set AGI threshold.

For 2014, the AGI threshold is $305,050 for married filers, $279,650 for head of household filers, and $254,200 for single filers.[258] For taxpayers with AGIs exceeding this threshold, a phase-out is calculated based on a formula. These taxpayers must reduce their total itemized deductions by 3% of the excess of their itemized deductions over the threshold AGI. In no event can more than 80% of total itemized deductions be eliminated. To depict the workings of this new phase-out, here is an example for a wealthy married couple.

<u>Example:</u> Joan and Ted are married and file a joint return for 2014. Their AGI for the year is $405,050. Joan and Ted have the following itemized deductions for 2014: (a) home mortgage interest of $10,000; (b) property taxes of $3,000; and (c) charitable contributions of $12,000, for a total of $25,000. Their reduction in their itemized deductions is the lesser of (1) [.03 x ($405,050 - $305,050) =$3,000], or (2) [.80 x $25,000 =$20,000]. Their reduction is therefore $3,000, meaning only $22,000 of their itemized deductions are allowed.

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257 American Taxpayer Relief Act of 2012 (Public Law 112-240), adding Sec. 68(b) to the IRC

258 IRS, Revenue Procedure 2013-35, Section 14.

The new law would cause Joan and Ted to lose tax savings of over $1,000. Furthermore, this phase-out can affect even higher income taxpayers more severely, because the formula reduces itemized deductions at an increasing rate. This richest taxpayers in the U.S. could lose as much as 80% of their total itemized deductions. Whether this new reform has any impact on future donations by these individuals is a question for future studies to answer.

# CONCLUSIONS

Juxtaposing tax loopholes and expenditures reveals why one is often mistaken for the other. They both share numerous similarities: both are perfectly legal, cost substantial tax dollars, benefit specific groups and are equally controversial tax issues for similar reasons. They also both have a long history with the tax code, and are unlikely to disappear. Where they differ is in the existence of intent. While tax expenditures hardly ever create the effect that legislators were hoping for, they are consistent in benefiting the target that the legislators intended.

Tax loopholes, on the other hand, take advantage of vulnerabilities in a tax law that were not originally accounted for during their enactment, providing incidental benefits to unintended targets. They are not created, but *discovered*. Some tax loopholes exist for decades before being revealed. In many cases, changes in technology or in the corporate environment can expose these loopholes. Such was true in the case of the Amazon Tax Loophole, where Internet retailers exploited a ruling decided during the days of mail-order retail. In other cases, mere oversight—such as with the “Black Liquor Credit”—can result in immediate exploitation that cannot be reversed. While there are some loopholes that are closed through tax reform immediately, there are others that continue to exist today. This is because there is not always a consensus on where the source of the loophole is. In addition, tax reform can be very complex, because the implications of different reform approaches, as well as the allocation of resulting tax revenue, are often highly disputed. As a result, there are even disagreements between government officials, as seen with the S Corporation Tax Shelter. While either side may agree that a loophole exists, they may not agree on how to close it.

Tax expenditures are a method of spending employed by the government through the tax code.  The advantages of tax expenditures over direct spending are its convenience and its subtlety.  For example, a government welfare program would be costly, difficult to manage and easily criticized in comparison to the Earned Income Tax Credit (EITC).  Taxpayers often overlook the fact that tax expenditures like the EITC are a method of subsidizing low-income taxpayers.  Consequently, tax expenditures that are not liked by the public are typically incorrectly referred to as loopholes.  But unlike loopholes, tax expenditures are a *conscious decision* made by the government, thus they are created, not discovered.  They also suffer from inherent flaws—such as inequitable tax treatment—that they are constantly criticized for, and the government is aware of.  Despite these flaws, tax expenditures are normally very difficult to remove (if not impossible) once enacted because their beneficiaries often lobby for continued or increased benefits.  At most, they receive various adjustments over time, such as in the case of the preferential capital gains rate and the charitable contributions deduction.  But even when tax expenditures do experience reform, the process is often complicated because reform methods are not usually agreed upon.

The distinction between loopholes and tax expenditures is important because of the different connotation each term has.  The reason why both are often confused is because inequitable tax treatment is associated with loopholes.  As such, tax expenditures that seem "unfair" for benefiting the wealthy are misconstrued as tax loopholes.  One should also consider the possibility that presenting a tax expenditure as a loophole makes it easier to forward a political agenda.  Confusion between tax loopholes and expenditures makes the real issues difficult to see.  For example, 2012 presidential candidate Mitt Romney's use of the carried interest loophole was at times distorted into a political debate about capital gains taxation.[259] While capital gains did play a role in the carried interest loophole, it was not the central issue at all. The preferential capital gains rate's reputation as a “loophole” overshadowed carried interest, garnering more political attention. Both tax loopholes and tax expenditures are important tax issues today. But the distinction between both needs to be clear in order for proper reform to take place.

As mentioned during the preceding chapter on tax expenditures, tax legislation at the end of 2012 did make some attempt at reforming tax expenditures, though some would argue the attempt was to close loopholes. Not only did the legislation create a new higher marginal income tax rate of 39.6% on the wealthiest of taxpayers, it also raised the capital gains tax rate to 20% from 15%.[260] Moreover, the 2012 legislation eliminated, through its phase-out regime, much of the itemized deductions, including the home mortgage interest deduction, for the very highest of income earners. As of this writing, that has been the most prominent of recent attempts to address the tax expenditure issue, or to “close loopholes” in the minds of some. However, the 2012 act, though mollifying public opinion to some extent (probably the chief reason for its enactment rather than a serious attempt at reform), only served to make the compliance with tax law ever more complicated. Perhaps that will always be the case, viz., the trade-off of addressing the tax expenditure and tax loophole issue is an ever-increasing problem in the arcane and obtuse Internal Revenue Code.

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259 For an example, see Burman, L. (2012, January 18). Mitt Romney's Teachable Moment on Capital Gains. *Forbes.* Retrieved from http://www.forbes.com/sites/leonardburman/2012/01/18/mitt-romneys-teachable-moment-on-capital-gains/

260 American Taxpayer Relief Act of 2012 (Public Law 112-240).