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ANALYSIS OF SPECIFIC TAX PROVISIONS IN PRESIDENT OBAMA'S FY2015 BUDGET

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ABSTRACT

This document reviews several notable tax proposals in President Obama's fiscal year 2015 Budget. These include expanding the earned income tax credit (EITC) for workers without qualifying children, expanding the child and dependent care tax credit for families with young children, conforming rules for self-employment contributions act (SECA) taxes for professional service businesses, and changing business taxes to create a reserve to fund long-run revenue-neutral business tax reform.

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I. INTRODUCTION

While the president's fiscal year 2015 budget mostly recycles prior year tax provisions, there are a few notable new proposals.[1] As in prior budgets, the president's plan would raise taxes on high-income households, close various loopholes, make permanent some temporary tax provisions, and reform the U.S. international tax system. In total, the president's tax proposals would raise revenue by an estimated $1.05 trillion over ten years.[2] That total would include $1.19 trillion of tax increases, partially offset by $140 billion of tax cuts.

This document examines four major new tax proposals in the president's budget:

- expand the earned income tax credit (EITC) for workers without qualifying children;
- expand the child and dependent care tax credit for families with young children; and
- conform self-employment contributions act (SECA) taxes for professional service businesses.
- create a reserve for long-run revenue-neutral business tax reform;

The Tax Policy Center has also estimated the overall distributional effects of the president's proposals. Tables showing those effects are available on our website at http://taxpolicycenter.org/numbers/displayatab.cfm?template=simulation&SimID=488.

II. EXPAND THE EARNED INCOME TAX CREDIT FOR WORKERS WITHOUT QUALIFYING CHILDREN

The earned income tax credit (EITC) provides substantial support to low-income working families. In 2012, the credit lifted 6.5 million people out of poverty[3], including about 3.3 million children (Center on Budget and Policy Priorities, 2014). The EITC alleviates poverty through two mechanisms – by providing cash assistance and by encouraging people to work. Nearly all (97 percent) EITC benefits accrue to families with at least one custodial child (Bryan, 2012). President Obama proposes to expand the EITC for workers without qualifying children in three ways:

1. double the maximum credit;
2. extend the income range over which it applies; and
3. expand the age range over which it applies from 25-64 to 21-66.

[1] Tax proposals in the president's FY 2015 budget are explained in detail in *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals.*

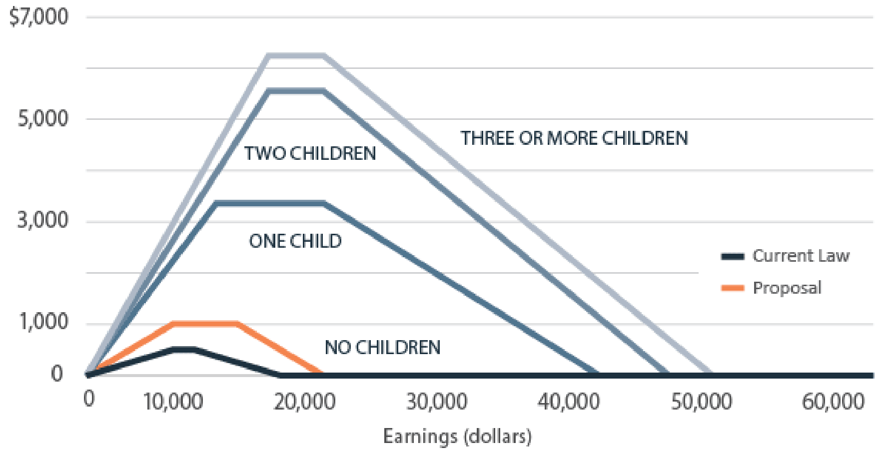
[2] All revenue estimates in this paper come from *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*.

[3] This estimate is based on the Supplemental Poverty Measure, which includes the value of tax credits and other anti-poverty programs in its measure of income.

The expansion would cost an estimated $60 billion between FY 2015 and FY 2024.

The EITC equals a fixed percentage of earnings until the credit reaches its maximum; both the percentage and the maximum credit depend on the number of children in the family. The credit remains at that maximum until earnings reach a phaseout range, above which the credit falls with each additional dollar of income until it disappears entirely (figure 1). The phaseout begins at a higher income for married couples than for others. The credit is fully refundable: any excess beyond a family's income tax liability is paid as a tax refund. The president proposes to double the maximum EITC for workers without qualifying children to nearly $1,000. The credit would phase in and phase out at a 15.3 percent rate, double the current 7.65 percent rate, and the maximum credit would go to workers with income between $6,500 and $11,500 (between $6,500 and $17,000 if married).

Figure 1: Earned Income Tax Credit for Unmarried People by Number of Children, 2015



Source: Tax Policy Center, 2014

Note: assumes all income is from earnings; phase-out for married couples begin $5,520 higher than for single filers.

The EITC encourages people—particularly single parents—to start working by subsidizing the wages of low-income workers (Eissa and Liebman 1996; Meyer and Rosenbaum 2001). At the same time, it may discourage some lower-earning spouses from getting jobs (Eissa and Hoynes 2004). Research studies find the latter effect to be substantially smaller than the former; that is, on balance, the EITC encourages work. The EITC for workers without qualifying children likely has little effect on work effort, due to its small size and the limited income range over which it applies.

The EITC for workers without qualifying children is not only small (the maximum credit is about $500, compared to between $3,300 and $6,300 for families with children); it also applies only over a narrow income range. Under current law, a single worker without qualifying children working full-time, year-round at the federal minimum wage will receive no credit in 2015—and only about $400 if she's married (assuming no change in minimum wage). The president's proposal would give that single worker a $460 credit and boost the credit to $1,000 if she's married. In addition, workers under age 25 or over age 64 without qualifying children cannot get an EITC. The president's proposal would expand the age range to 21 to 66. (Workers with children face no age limits.)

The EITC can impose substantial marriage penalties—the additional tax a married couple can pay compared with what they would owe if they were single. For example, a single parent who has two children and works full-time at minimum wage could get $5,500 of EITC in 2015. If she married a childless worker with the same minimum-wage earnings, the couple would get $4,200 in EITC—a marriage penalty of $1,300.[4] The President's proposal would exacerbate that marriage penalty because the childless worker would lose the $460 credit available to workers without qualifying children under the proposal, thus raising the family's marriage penalty to almost $1,800.

However, the president's proposal would also make permanent the higher point at which the EITC begins to phase out for married couples, which reduces marriage penalties for lower-income couples. The president would also make permanent the larger EITC for families three or more children. Both of these items were enacted as part of the 2009 American Recovery and Reinvestment Act and are scheduled to expire at the end of 2017.

III. EXPANDING THE CHILD AND DEPENDENT CARE TAX CREDIT FOR FAMILIES WITH YOUNG CHILDREN

President Obama proposes to give families with children under age 5 an additional childcare credit on top of the current child and dependent care tax credit (CDCTC). The new credit would cost an estimated $4.5 billion between FY 2015 and FY 2024.

The CDCTC offsets part of the costs associated with caring for a child while a parent (or both parents, if married) works, looks for work, or attends school. Parents may claim a credit of between 20 percent and 35 percent of up to $3,000 of expenses per child under age 13 (with a family maximum of $6,000). The credit percentage declines as adjusted gross income (AGI) rises. Because the credit is nonrefundable, families with no income tax liability (before the CDCTC and refundable credits) get no benefit from it. The Tax Policy Center (TPC) estimates that in 2013, nearly two-thirds of the benefit of the CDCTC went to families in the top two income quintiles, compared with just 1 percent going to families in the lowest quintile.

The president's proposal would allow families with children under age 5 to claim an additional non-refundable credit of as much as 30 percent of up to $4,000 in expenses per child under age 5 (and a family maximum of $8,000 of expenses). Because taxpayers could claim the same expenses for both the regular CDCTC and the additional CDCTC, the combination could give them a credit of up to 65 percent of the first $3,000 of childcare expenses for younger children ($6,000 for two or more younger children). The additional credit would phase out between $61,000 and $119,000 of AGI.

[4] The childless worker would get no EITC before the marriage so the marriage penalty would come entirely from a reduction in the parent's EITC.

The CDCTC gives families with AGI up to $15,000 a credit of 35 percent of their childcare expenses. That rate phases down by 1 percentage point for each $2,000 of AGI above $15,000 until it reaches a minimum rate of 20 percent when AGI exceeds $43,000. In contrast, the proposed additional credit would phase out completely—the rate would drop by 1 percentage point for each $2,000 of AGI over $61,000 until it reaches zero when AGI exceeds $119,000. Because the additional credit, like the CDCTC, would be nonrefundable, it would be of limited or no value to low-income families because they have little or no income tax liability against which to claim the credit. A single mother with two children, for example, would get no benefit from either credit until her income exceeds $21,200 (in 2015) and would not get the full benefit of both credits until her income is at least $50,000 (figure 2).

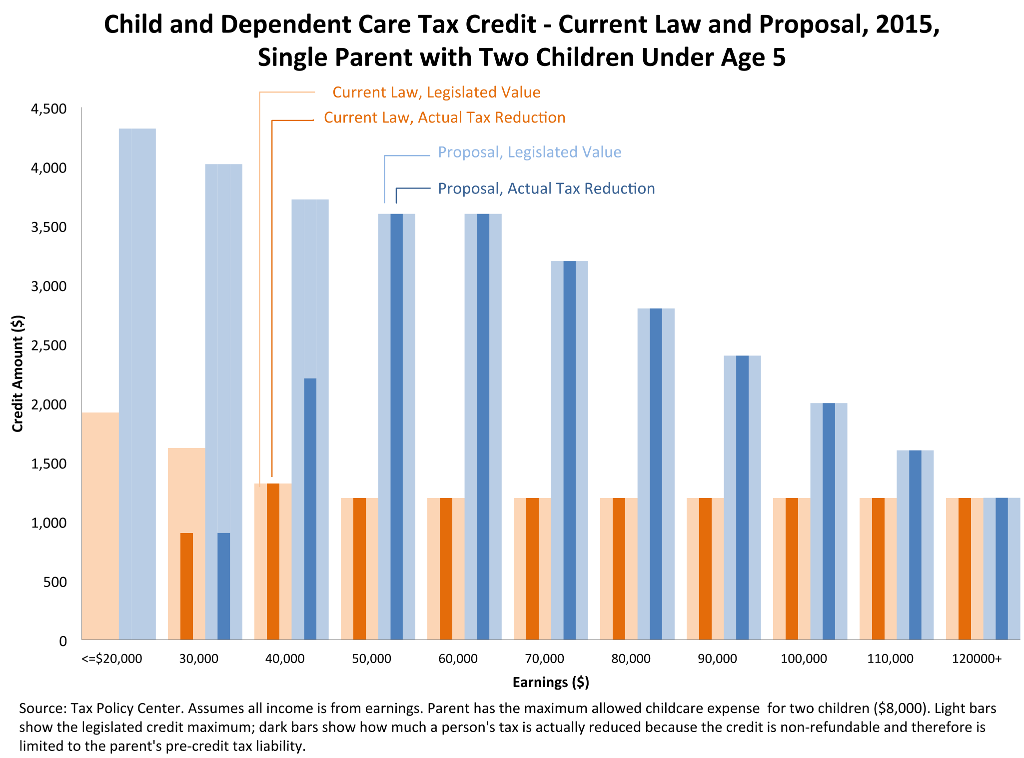


Figure 2

IV. PAYROLL TAXES FOR OWNERS OF PROFESSIONAL SERVICES BUSINESSES ORGANIZED AS PASS-THROUGHS

Employers and employees pay payroll taxes to fund Social Security retirement and disability benefits (OASDI) and Medicare hospital insurance benefits (HI) under the Federal Insurance Contribution Act (FICA). The combined employer and employee FICA rate is 15.3 percent on the first $117,000 (in 2014) of wages. Above this cap only the combined HI rate of 2.9 percent generally applies, but high-wage employees pay an additional surtax of 0.9 percent (for a total rate of 3.8 percent). Owners of pass-through businesses pay an equivalent tax on their earnings under the Self-Employment Contributions Act (SECA). The definition of earnings taxable under

SECA depends on the legal form of the pass-through business, the type of owner, and the form of the earnings.

SECA generally applies to all of the business income earned by a sole proprietor or by a general partner in a partnership. Limited partners are subject to SECA only on certain payments they receive for labor services they provide to the partnership. Limited liability companies (LLCs) are generally taxed as partnerships for federal purposes, but owners are not general or limited partners so the application of SECA to payments they receive is unclear under current law. Owners (shareholders) who work for a Subchapter S corporation are paid wages which are subject to FICA rather than SECA, and SECA does not apply to other income owners earn from the corporation.

The passive income of limited partners and LLC owners that is not subject to SECA is generally subject to the 3.8 percent surtax on net investment income that applies to individuals with high incomes from all sources. The net investment income tax, however, generally does not apply to the non-wage income received by owners who perform work for Subchapter S corporations (even though that income is not subject to SECA), to any of the business income received by general partners (all of which is generally subject to SECA), or to any of the business income received by active limited partners (even though little if any of that income may be subject to SECA).

The president proposes to apply SECA to all business income of active owners of Subchapter S corporations, partnerships, and LLCs engaged in providing professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, brokerage services, and lobbying. Wages of active Subchapter S owners would be included in their business income for SECA purposes and no longer be subject to FICA. Owners would be considered active if they materially participate in the business, which would typically require that they work for the business at least 500 hours per year. Passive owners of these pass-through businesses would be subject to SECA only on the "reasonable compensation" they receive for labor services. Investment income (e.g., interest, dividends, and capital gains) would continue to be excluded from the SECA base. The administration estimates that the proposal would increase SECA revenue by $37.7 billion over ten years.

The proposal would reduce the ability of pass-through owners engaged in professional services to avoid payroll tax on the compensation they receive for labor services by re-characterizing that compensation as non-wage income. Under current law, wages paid to owners of Subchapter S corporations are supposed to reflect "reasonable compensation" to prevent these business owners from avoiding payroll tax by paying themselves a low salary, thereby converting wage income into profits (popularly known as the Gingrich-Edwards loophole).[5] Because the reasonable compensation standard is difficult to interpret and enforce, some subchapter S owners do not pay either SECA or the net investment income tax on compensation they re-characterize as profits.

[5] 2012 presidential candidate Newt Gingrich was accused of escaping $69,000 of Medicare tax on earnings from his multimedia production company [Wall Street Journal, 2012], and 2004 vice presidential candidate John Edwards was accused of using this device to escape almost $600,000 in tax on his earnings as a trial lawyer [Wall Street Journal, 2004].

The proposal would prevent this by including all of an active owner's business income from an S corporation in the SECA base. Similarly, under the proposal, active limited partners and LLC owners who currently can characterize compensation for labor services as non-labor income and avoid SECA on that compensation would be subject to SECA on all business income. In addition to closing some avenues for payroll tax avoidance for pass-throughs engaged in professional services, the proposal would clarify the application of SECA to LLCs, and replace the "reasonable compensation" test with the simpler "material participation" test for active owners of Subchapter S corporations.

The proposal would prevent a form of tax avoidance used by some high-earning business owners. But by extending the SECA base to cover all returns to active business owners, including profits attributable to their capital investments, it could put some self-employed people at a disadvantage compared with employees for whom the payroll tax applies only to labor compensation. Because the proposal would apply the new SECA rules only to professional services businesses, which generally do not require significant capital investment, the distortion from subjecting returns to capital investments to SECA would be limited. But the distortion could be much larger if a similar approach were used to reduce SECA tax avoidance in other industries.

V. RESERVE FOR LONG-RUN REVENUE-NEUTRAL BUSINESS TAX REFORM

President Obama has called for a business tax reform that would broaden the tax base and reduce the corporate tax rate without increasing the deficit. He would also expand certain incentives to promote domestic manufacturing and innovation and provide measures to simplify and reduce taxes for small business. Towards this end, a subset of proposals in the budget, including proposals that both raise and lose revenue, are set aside as a "reserve for revenue-neutral tax reform" and not counted in budget totals.

Taken together, the proposals dedicated to the reserve for tax reform would raise $248 billion between fiscal years 2015 and 2024, less than 5 percent of the $5.3 trillion projected baseline for corporate receipts over those 10 years. That suggests that the changes could pay for at most 2 percentage points of corporate rate reduction, cutting the top rate from the current 35 percent to about 33 percent.

The proposals included in this reserve for tax reform are listed under seven sub-headings:

1. <u>Incentives for Manufacturing, Research, Clean Energy, and Insourcing and Creating Jobs</u>. The president proposes a variety of new and expanded business tax incentives, which would reduce federal receipts by $143.4 billion over 10 years. The largest of these proposals ($108 billion over 10 years) would enhance and make permanent the tax credit for research and experimentation, which expired at the end of 2013. This credit has been extended 14 times since its original enactment in 1981. Although it expired at the end of 2013, it will almost certainly be extended again on a retroactive basis (as it has several times in the past). There's some debate in the economics literature about how effective the credit is at spurring new research. Making the credit permanent might increase its effectiveness in spurring new

research if firms do not invest in research plans that could take many years to reach fruition because they worry that Congress might allow the credit to expire. The president also proposes to extend and make permanent the production tax credit for renewable energy ($19 billion), extend and modify employment tax credits (about $10 billion), and make other small changes.

2. Tax Relief for Small Business. The president proposes to extend and expand provisions that provide tax relief for small business at a cost of almost $72 billion over 10 years. The largest of these proposals would extend the temporarily higher amounts of investment in qualified machinery and equipment that businesses can expense (deduct immediately) instead of recovering over time through depreciation deductions. Extending the higher limits on expensing would cost almost $57 billion over 10 years.

3. Incentives to Promote Regional Growth. The president would make the New Markets Tax Credit (which subsidizes investments in economically distressed areas) permanent, provide tax incentives for transportation infrastructure, and reform and expand the low-income housing tax credit (which is permanent under current law). These proposals would reduce receipts by $12 billion over 10 years.

4. Reform the U.S. International Tax System. The budget reserve includes numerous proposals that would raise revenue by increasing taxes on foreign-source income of U.S. multinational corporations. These include proposals to a) defer a portion of interest deductions to the extent the firm earns foreign-source income that is deferred from US tax; b) tighten limits on foreign tax credits a firm may claim against repatriated foreign income; and c) limit shifting of reported income to low-tax jurisdictions through the transfer of intangible property (such as patents and goodwill) and through excess interest deductions. Taken together, the proposals would raise taxes on the foreign-source income of U.S. multinational corporations, limit corporate base erosion through the shifting of reported income overseas, and make it less advantageous for a multinational to be incorporated in the United States. To counter corporate responses to the latter effect, the president would also tighten rules that limit the ability of U.S. resident corporations to expatriate through so-called inversion transactions that shift corporate residence overseas. Overall, the international tax proposals included in the "reserve" would raise receipts by $276 billion over 10 years.

5. Reform Treatment of Financial and Insurance Industry Institutions and Products. The president would raise another $31 billion over 10 years for the reserve through reforms affecting financial transactions and institutions. The largest of these measures ($18 billion) would require derivative contracts to be marked to market (that is, require annual recognition of accrued gains or losses), with the resulting gain or loss taxable as ordinary income.

6. Eliminate Fossil Fuel Preferences. The president proposes to eliminate various long-standing tax subsidies for exploration and development of oil, natural gas, and coal, thereby raising another $48 billion over 10 years. The largest of these preferences are percentage depletion and expensing of intangible drilling costs. The president would also repeal the domestic manufacturing deduction for oil, natural gas, and coal—currently 6 percent of

income for oil and gas and 9 percent for coal and most other manufacturing. (The current domestic manufacturing deduction is equivalent to a cut in the top corporate rate on oil and gas extraction from 35 to 32.9 percent and the top rate on coal extraction from 35 to 31.9 percent).

7. Other Revenue Changes and Loophole Closers. A variety of other proposals for the reserve would raise $119 billion over 10 years. The largest of these would repeal the last-in, first-out (LIFO) method of accounting for inventories. In combination with a proposal to repeal the lower of cost or market inventory accounting method, this would raise about $90 billion over 10 years by reducing the deductions taken on most goods sold out of inventory and thereby increasing taxable profits. A proposal to modify like-kind exchange rules for real property, which currently allow firms to postpone capital gains on many large real estate transactions, would raise another $18 billion over 10 years.

In addition to these proposals, the budget also claims that $150 billion in receipts would be generated from FY 2015 through FY 2018 by the transition to a reformed business tax system, including unspecified provisions to reform accelerated depreciation and to tax some of the profits that U.S. corporations have accrued in foreign subsidiaries. These provisions are not specified in the budget or the Treasury's list of revenue proposals. They would be used to pay for one-time investments in transportation infrastructure.

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