

# ISSUE BRIEF

No. 4187 | MARCH 31, 2014

## Tax Extenders an Opportunity to Improve the Tax Code

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The tax extenders are a group of approximately 50 tax-reducing policies that expire regularly. Congress has traditionally extended them just as regularly as they expire.

Most recently, they expired at the end of 2013, and Congress has yet to address them this year. Congress previously extended them as part of the “fiscal cliff” deal struck at the beginning of 2013. That deal enacted the extenders retroactively for 2012 and for the rest of 2013.

New chairman of the Senate Finance Committee Ron Wyden (D-OR) and chairman of the House Ways and Means Committee Dave Camp (R-MI) will mark up bills on the tax extenders soon. If handled properly, the tax extenders would be an opportunity for Congress to improve tax policy.

**Extension Is Not a Tax Cut.** If Congress is to use the extenders constructively to advance sound policy, it must first not fall into the trap of trying to pay for extending the extenders to offset their cost, a mistake that routinely plagues this issue and bogs Congress down from making meaningful improvements.

The problem arises because of the incorrect way the Congressional Budget Office (CBO) constructs its revenue baseline. CBO assumes that Congress

intends to allow expiring tax-reducing provisions, such as the tax extenders, to *expire* permanently. This is contrary to the way it estimates its discretionary spending baseline, where it assumes that Congress intends expiring spending programs such as the farm program, highway spending, and annual appropriations to *continue* permanently.

As a result, expiring tax-reducing provisions raise CBO’s revenue estimates higher than they would be if CBO treated revenue the same way it treats discretionary spending. Because it wrongfully assumes that expiring tax provisions raise revenue, it also wrongfully considers Congress’s restoring those policies to be a tax cut.

Under the budgeting rules Congress follows, it must offset policies that increase spending or lower taxes so as not to add to the deficit. It can do so by either lowering spending or raising taxes in other areas. Since CBO’s faulty revenue baseline wrongly scores extending the tax extenders as a tax cut that adds to the deficit, some feel the need to offset their extension.

Congress should not have to accommodate CBO’s error. Extending the tax extenders is not a tax cut. These policies have long been in place, some—such as the Research and Experimentation (R&E) Credit—for 30 years. If they expire, taxes will rise on those taxpayers who use them. Extending them prevents a tax increase, and there is no need for Congress to offset their cost.

If Congress insists on paying for their extension by raising other taxes, it will create an oxymoronic condition where it is raising some taxes to prevent raising others. And, of course, raising taxes is not sound policy.

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This paper, in its entirety, can be found at <http://report.heritage.org/ib4187>

Produced by the Thomas A. Roe Institute for Economic Policy Studies

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**Go Through Policies Individually.** Congress should also not fall into the trap of extending all the policies that make up the tax extenders *en bloc*. The various provisions in the package are of varying merit as they pertain to tax neutrality.

Congress should go through each individual policy in the extenders package and evaluate them on their necessity for neutrality. It should retain those that pass the test and eliminate those that do not.

Examples of policies that are vital to a neutral tax code or are necessary because of the current structure of the system include:

- The R&E credit;
  - Exception from Subpart F income for active financing income;
  - Expensing of capital costs for small businesses (section 179 expensing);
  - 50 percent bonus depreciation;
  - Treatment of regulated investment companies;
  - Deduction for state and local general sales taxes; and
  - Tax-free distributions from an individual retirement account for charitable purposes.
- Policies that harm the neutrality of the tax code that Congress should eliminate include:<sup>1</sup>
- Credits for producing biodiesel and renewable diesel;
  - Credits for producing or selling alternative fuel and alternative fuel mixtures;
  - The Alternative Fuel Vehicle Refueling Property Credit (for installing alternative-fuel mechanisms);
  - Income tax credits and excise tax credits for producing or using ethanol;
  - Renewable electricity production credit and the optional investment credit (better known as the wind tax credits);
  - Credit for construction of homes designated by the government as energy efficient;
  - Credit for producing appliances designated by the government as energy efficient;
  - Credit for improving the energy efficiency of existing homes;
  - New-markets tax credit;
  - Empowerment-zone tax incentives;
  - Enhanced mass-transit subsidies; and
  - Low-income housing provisions.

There are other policies in the package that represent sound policy but are narrowly construed to apply only to certain industries. They pose a greater challenge.

One example is shorter depreciation schedules for capital purchased by restaurants and retail stores, motorsport racing track facilities, businesses on Indian properties, certain film and television productions, and a variety of other specific industries. For those industries that qualify, these policies move the tax code closer to expensing—i.e., allowing businesses to deduct immediately the cost of their capital expenses, which is the proper policy. But not all businesses can benefit from these incremental improvements. It would be better policy if all businesses could use them.

The increased payment of excise taxes on imported rum to Puerto Rico and the Virgin Islands pertains to the governance of U.S. territories and is best dealt with outside tax legislation.

**Make Pro-Growth Changes So No Tax Hike.** Eliminating those policies that do not pass the test, however warranted, would constitute a tax increase. For this reason, Congress should treat the elimination of unsound policies in the tax extenders as a

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1. For an explanation of why these policies violate neutrality, see Curtis S. Dubay, "Tax Extenders and the AMT Patch: Time to Pull the Plug on Congress's Annual Dance," Heritage Foundation *Backgrounder* No. 2654, February 16, 2012, <http://www.heritage.org/research/reports/2012/02/tax-extendors-and-the-amt-patch-time-to-pull-the-plug-on-congresss-annual-dance>.

small-scale tax reform and institute pro-growth changes in the tax code that reduce taxes by the amount of revenue that eliminating unsound policies would raise. That way, the entire bill is revenue neutral and would improve economic growth.

All areas of the code need improving, which is why fundamental tax reform is needed. A few places Congress could look to make incremental improvements that would strengthen the economy include:

- Expanding section 179 expensing so small businesses can expense all of their capital expenditures,
- Exempting taxpayers from paying interest on all or a portion of their savings, and
- Making it easier for all families to save more for whatever reason they deem necessary.

It would be best if the committees chose which policy improvements they intend to make with the revenue raised from eliminating certain extenders first. That way, they could weigh the foregone benefit of that improvement against keeping unjustified tax extenders.<sup>2</sup>

**Make Continued Extenders Permanent.** If Congress follows this sensible and long-overdue approach to the tax extenders, it should make those policies it continues permanent so it does not have to do this routine annually. It should then turn its attention to fundamental tax reform, where it could do a great deal more to free the economy to grow at its potential.

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2. J. D. Foster, "Tax Extenders Review Needs a Framework," Heritage Foundation *Issue Brief* No. 3586, May 1, 2012, <http://www.heritage.org/research/reports/2012/05/tax-extendere-review-needs-a-framework>.