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## Senate Revenue Package Is Sound Policy

By Samantha Jacoby, Chuck Marr, and Chad Stone

The Inflation Reduction Act before the Senate would make important investments in climate and energy initiatives, lower the cost of medicines for seniors and other Medicare recipients, extend critical tax credits to help millions of households afford health insurance purchased through state exchanges, and it is expected to reduce the monthly cost of insulin for people with diabetes. To pay for these investments and reduce the deficit, the bill includes a revenue package with three main elements, all of which are sound tax policies individually. Specifically, the revenue changes would:

- **Increase IRS funding to reduce the tax gap.** The IRS budget was cut sharply during the 2010s and remains about 20 percent below its 2010 level, after adjusting for inflation. The staff of auditors who handle the most complex returns, from high-income individuals and large corporations, has shrunk by 40 percent since 2010, and the agency's computer systems are woefully out of date. The Senate bill includes roughly \$80 billion in ten-year funding<sup>1</sup> to give the IRS the resources and funding certainty to rebuild and train its staff and to make long-term investments in its computer systems.<sup>2</sup> Those changes, in turn, would improve taxpayers' experience with the IRS and enable the agency to collect more of the taxes that are legally owed, particularly from high-income people. In fact, the \$80 billion investment would produce roughly \$200 billion in revenue over ten years, for a net savings estimated at \$124 billion, according to Congressional Budget Office (CBO) estimates.<sup>3</sup> (Many analysts estimate that the net savings would be substantially higher.<sup>4</sup>)
- **Require corporations to pay a 15 percent minimum tax.** The 2017 tax law drastically cut the corporate tax rate (from 35 percent to 21 percent), adopted generous immediate

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<sup>1</sup> The ten-year period covered by the reconciliation bill is fiscal years 2022-2031. The \$80 billion is mandatory funding, which would come on top of the base appropriations for the IRS. See Chuck Marr *et al.*, "Rebuilding IRS Would Reduce Tax Gap, Help Replenish Depleted Revenue Base," CBPP, April 13, 2021, <https://www.cbpp.org/research/federal-tax/rebuilding-irs-would-reduce-tax-gap-help-replenish-depleted-revenue-base>.

<sup>2</sup> Chuck Marr *et al.* "Congress Needs to Take Two Steps to Fund the IRS for the Short and Long Term," CBPP, February 1, 2022, <https://www.cbpp.org/research/federal-tax/congress-needs-to-take-two-steps-to-fund-the-irs-for-the-short-and-long-term>.

<sup>3</sup> Congressional Budget Office, "Estimated Budgetary Effects of H.R. 5376, the Inflation Reduction Act of 2022," August 3, 2022, <https://www.cbo.gov/publication/58366>.

<sup>4</sup> Samantha Jacoby, "Revenue from BBB's IRS Enforcement Funding Would Support Investments," CBPP, November 17, 2021, <https://www.cbpp.org/blog/revenue-from-bbbs-irs-enforcement-funding-would-support-investments>.

“expensing” for equipment purchases, and established a coherent but weak international tax regime. These provisions resulted in large tax cuts to corporations and substantial revenue loss, while failing to reverse the flow of profits to tax havens; they also had little if any positive impact on business investment and wages. Moreover, dozens of the largest multinationals pay no or low corporate taxes in a given year, despite reporting record-high profits to shareholders. Although the Senate bill does not raise the 21 percent corporate rate or directly change the international tax rules, it establishes a new 15 percent minimum tax on the “book” profits (the profits reported to shareholders) of the largest, most profitable corporations — those reporting book profits of over \$1 billion. This would raise an estimated \$313 billion over ten years.<sup>5</sup>

- **Narrow the carried interest loophole.** A long-standing loophole in the tax code allows managers of private equity and other investment funds to pay lower taxes on their compensation than wage and salary earners do. The 2017 tax law narrowed the loophole slightly by requiring fund managers to hold their investments in the fund for more than three years to qualify for the special low capital gains tax rate on the income they receive in exchange for their services. The Senate bill would take another step forward, extending the required holding period to five years, which is more in line with how long private equity funds typically hold their investments. This modest but important proposal would raise \$13 billion over ten years.<sup>6</sup>

Together, these tax policy changes would generate \$450 billion in revenue through 2031. These revenues would more than offset the cost of the bill’s critical \$360 billion investment to address climate change.<sup>7</sup> In effect, the bill would use revenue collected from improving tax enforcement and raising taxes on some highly compensated executives and large, profitable corporations to expand the nation’s ability to produce and deploy cleaner energy technology and sources. Overall, the bill “can cut US net greenhouse gas emissions down to 31% to 44% below 2005 levels in 2030 ... compared to 24% to 35% under current policy,” according to preliminary estimates from the Rhodium Group.<sup>8</sup>

The bill would represent a major policy advance and its impact on the macroeconomy, while more modest, would be positive. The Fed has been tightening monetary policy, including raising interest rates sharply, with the goal of reducing the rate of inflation without triggering a severe recession and large job losses. The Senate bill, with roughly \$300 billion in deficit reduction over the decade and new measures to reduce prescription drug costs, would lean toward reducing inflationary pressures. Despite what critics may claim, the bill’s tax policies that restore some fairness to the tax code would

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<sup>5</sup> Estimated Budget Effects of the Revenue Provisions of Title I – Committee on Finance, Estimate to be Provided by the Congressional Budget Office, of an Amendment in the Nature of a Substitute to H.R. 5376, the “Inflation Reduction Act of 2022,” July 28, 2022, <https://www.finance.senate.gov/imo/media/doc/7.29.22%20Estimate%20of%20Manchin%20Schumer%20agreement.pdf>.

<sup>6</sup> *Ibid.*

<sup>7</sup> As noted, the bill also includes provisions that would reduce prescription drug costs for the federal government (as well as consumers). Those savings more than offset the cost of the health investments.

<sup>8</sup> Ben King, John Larsen, and Hannah Kolus, “A Congressional Climate Breakthrough,” Rhodium Group, July 28, 2022, <https://rhg.com/research/inflation-reduction-act/>.

not have a negative impact on jobs and investment. And its investments in climate change will pay dividends over time.

In a letter to congressional leaders, over 100 economists summed it up: the legislation “makes crucial investments in energy, health care, and in shoring up the nation’s tax system. These investments will fight inflation and lower costs for American families while setting the stage for strong, stable, and broadly-shared long-term economic growth.” The letter also explains that the bill “represents the single biggest step to date in tackling the climate crisis.”<sup>9</sup>

## Collecting More Taxes Legally Owed

Several factors have coalesced to create an urgent need for a multi-year rebuilding of the IRS to address the roughly \$600 billion annual gap between taxes legally owed and taxes paid — a gap that is grossly unfair to honest taxpayers and business owners. The Senate bill provides roughly \$80 billion in ten-year funding for this essential task, which would raise \$204 billion over the period for net savings of \$124 billion, CBO estimates.<sup>10</sup> (Others have suggested the revenue collected could be higher.<sup>11</sup> For example, former Treasury Secretary Larry Summers recently said that “I think one is completely safe in saying above \$500 billion, and my honest guess is closer to \$1 trillion.”<sup>12</sup>) Critically, this additional funding is designed as multi-year, mandatory funding — that is, it would be provided directly in authorizing law rather than through annual appropriations<sup>13</sup> — to give the IRS the certainty it needs to rebuild its audit staff and make long-term commitments to technology upgrades.

The added funding is especially vital given the depleted state of the IRS. Overall IRS funding is down one-fifth since 2010, after adjusting for inflation, and a decade of budget cuts has severely undermined the agency’s ability to perform its fundamental jobs of enforcing the nation’s tax laws and helping taxpayers navigate a tax system that relies on voluntary compliance. Since 2010, the IRS’s computer systems have become more outdated and the number of revenue agents — auditors uniquely qualified to process the complex returns of high-income individuals and corporations — has fallen by 40 percent.

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<sup>9</sup> Letter to Senate Majority Leader Schumer, Senate Minority Leader McConnell, House Speaker Pelosi, and Minority Leader McCarthy, August 2, 2022, <https://www.documentcloud.org/documents/22124998-letter-from-economists-to-congressional-leadership>.

<sup>10</sup> Senate Majority Leader Chuck Schumer and Senator Joe Manchin, “Summary: The Inflation Reduction Act of 2022,” July 27, 2022, [https://www.democrats.senate.gov/imo/media/doc/inflation\\_reduction\\_act\\_one\\_page\\_summary.pdf](https://www.democrats.senate.gov/imo/media/doc/inflation_reduction_act_one_page_summary.pdf).

<sup>11</sup> Jacoby, *op. cit.*

<sup>12</sup> Josh Barro, “The Big Question About the Inflation Reduction Act: How Well Will Added Tax Enforcement Work?” Very Serious, July 30, 2022, <https://www.joshbarro.com/p/the-big-question-about-the-inflation>.

<sup>13</sup> Marr *et al.*, “Rebuilding IRS Would Reduce Tax Gap, Help Replenish Depleted Revenue Base.”

The vast majority of Americans receive most of their income from wages and salaries, and because employers withhold income and payroll taxes from their paychecks, their rate of tax compliance is nearly perfect — over 99 percent, according to the IRS.<sup>14</sup> Obviously, these are not the kinds of tax returns that the IRS targets for audits, contrary to claims by some critics.

But other types of income are more opaque, making them harder for the IRS to trace to a specific individual, and are concentrated<sup>15</sup> at the top of the income spectrum. Partnership income, for example, is especially hard to trace because of complex, multi-layered ownership structures.<sup>16</sup> As a result, a significant share of partnership income — around 11 percent, according to the IRS — is misreported.<sup>17</sup>

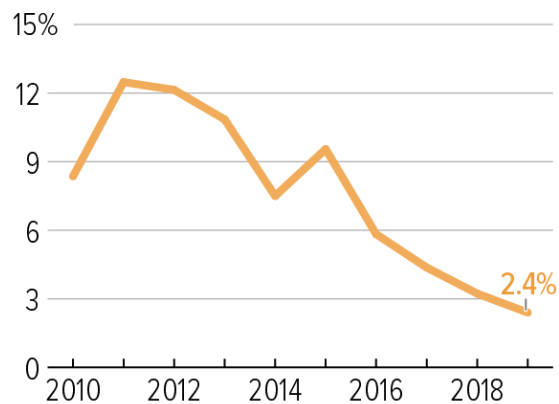
Due to these and other factors, wealthy people’s tax returns are complex and auditing them is labor intensive. And, largely because of the sharp drop in the number of revenue agents, the audit rate of millionaires has plummeted 71 percent since 2010. (See Figure 1.) A key goal of the new funding is to enable the IRS to reverse that decline by hiring and training more auditors. This task is especially critical given that the top 1 percent of filers account for an estimated 28 percent of the tax gap.<sup>18</sup>

This Senate bill delivers the essential additional funding — \$45 billion for tax enforcement and \$25 billion for corresponding operations support, nearly \$5 billion for systems modernization, and over \$3 billion for taxpayer services — to build the IRS’ capacity to narrow the tax gap and improve tax return processing.

FIGURE 1

## Audits on Millionaires Have Fallen 71 Percent Since 2010

Audit rate, by fiscal year



Note: Millionaires = filers with incomes greater than \$1 million.

Source: IRS Data Books, 2010-2019

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<sup>14</sup> Barry W. Johnson and Peter J. Rose, “Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013,” Internal Revenue Services, September 2019, <https://www.irs.gov/pub/irs-pdf/p1415.pdf>.

<sup>15</sup> Thirty-five percent of partnership and S corporation income flows to people with incomes above \$500,000. Natasha Sarin, “The Case for a Robust Attack on the Tax Gap,” U.S. Department of the Treasury, September 7, 2021, <https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap>.

<sup>16</sup> Michael Cooper *et al.*, “Business in the United States: Who Owns It, and How Much Tax Do They Pay?” *Tax Policy and the Economy*, Vol. 30, October 2016, <https://scholar.princeton.edu/sites/default/files/zidar/files/cmppsyz-2016.pdf>.

<sup>17</sup> Johnson and Rose, *op. cit.*

<sup>18</sup> Sarin, *op. cit.* The author based this estimate on Jason DeBacker *et al.*, “Tax Noncompliance and Measures of Income Inequality,” *Tax Notes*, February 17, 2020.

## Setting 15 Percent Minimum Tax on Corporate Book Profits

The cornerstone of the 2017 tax cuts under President Trump was a deep, regressive cut in the corporate tax rate from 35 percent to 21 percent and a shift toward a “territorial” tax system, which exempts certain foreign income of U.S. corporations from tax.<sup>19</sup> The law also expanded certain other tax benefits for businesses — for example, allowing them to fully expense (that is, deduct for tax purposes) the cost of their investments upfront, rather than over several years.<sup>20</sup> These changes went far beyond many previous Republican corporate tax proposals. In 2014, for example, then-House Ways and Means Committee Chair Dave Camp proposed cutting the corporate rate to 25 percent while requiring businesses to *extend* the length of depreciation schedules to more closely match the economic lives of various assets.<sup>21</sup>

Despite the 2017 law’s dramatic rate cut, the large economic benefits that its proponents promised have been hard to find. William Gale and Claire Haldeman of the Brookings Institution found that the corporate tax cut “had little impact on business investment through 2019 (at which we stopped the analysis, to avoid confounding [the law’s] effects with those of the COVID-related shutdowns that ensued)” and that employment and wage growth actually slowed in the years following the law’s passage.<sup>22</sup> Instead, the tax cut largely benefited corporate shareholders, the vast majority of whom are wealthy households and foreign investors.<sup>23</sup>

Though the Senate bill would not raise the statutory corporate tax rate, it would raise the effective tax rate — the total taxes paid as a share of pre-tax profits — for some of the largest multinational corporations by imposing a new 15 percent minimum tax on the profits they report to shareholders, known as “book” income (or book profits). Book income is often much higher than taxable income and may better represent a company’s true economic position. As the Institute on Taxation and Economic Policy has found, dozens of the largest corporations often pay no or very low federal income taxes on their substantial profits because of the low corporate tax rate, the many tax credits and deductions available for businesses, and the ability to shift profits to tax havens.<sup>24</sup> The Senate

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<sup>19</sup> The 2017 law added several provisions, including the “GILTI” minimum tax, to try to limit the incentive for profit shifting that a territorial tax system exacerbated. These provisions have serious design flaws, however, and do not adequately limit international tax avoidance. See Samantha Jacoby, “International Tax Reform Proposals Would Limit Overseas Profit Shifting, End ‘Race to the Bottom,’” CBPP, July 11, 2022, <https://www.cbpp.org/research/federal-tax/international-tax-reform-proposals-would-limit-overseas-profit-shifting-end>.

<sup>20</sup> The law enacted full expensing for most assets through 2022, converting gradually to decreasing bonus depreciation from 2023 through 2026.

<sup>21</sup> Tax Policy Center, “The Tax Reform Act of 2014: Fixing Our Broken Tax Code So That It Works for American Families and Job Creators, House Ways and Means Committee,” updated May 2020, <https://www.taxpolicycenter.org/briefing-book/tax-reform-act-2014-fixing-our-broken-tax-code-so-it-works-american-families-and-job>.

<sup>22</sup> William Gale and Claire Haldeman, “Searching for supply-side effects of the Tax Cuts and Jobs Act,” Brookings Institution, July 6, 2021, <https://www.brookings.edu/research/searching-for-supply-side-effects-of-the-tax-cuts-and-jobs-act/>.

<sup>23</sup> Chuck Marr *et al.*, “Corporate Rate Increase Would Make Taxes Fairer, Help Fund Equitable Recovery,” CBPP, May 25, 2021, <https://www.cbpp.org/research/federal-tax/corporate-rate-increase-would-make-taxes-fairer-help-fund-equitable-recovery>.

<sup>24</sup> Matthew Gardner and Steve Wamhoff, “55 Corporations Paid \$0 in Federal Taxes on 2020 Profits,” Institute on Taxation and Economic Policy, April 2021, <https://itep.sfo2.digitaloceanspaces.com/040221-55-Profitable-Corporations-Zero-Corporate-Taxes.pdf>.

bill's minimum tax would raise \$313 billion over ten years, according to the Joint Committee on Taxation (JCT).<sup>25</sup> It would only apply to very large and profitable corporations — companies with book profits averaging more than \$1 billion per year on average over three years.

Some opponents have tried to argue that this corporate minimum tax is actually, in some indirect way, a tax on working and middle-class people. This is a distraction that takes President Biden's campaign pledge not to raise taxes on anyone with income under \$400,000 to a ridiculous level. In a statement supporting the bill, five former Treasury secretaries from both Democratic and Republican administrations were unequivocal: "Taxes due or paid will not increase for any family making less than \$400,000/year."<sup>26</sup> They further pointed out, "The selective presentation by some of the distributional effects of this bill neglects benefits to middle-class families from reducing deficits, from bringing down prescription drug prices, and from more affordable energy." Nobel economist Paul Krugman also highlighted that not one middle-class person "making, say, 75K a year will see a bigger number on their 1099," before concluding such claims are "obvious nonsense."<sup>27</sup>

Others are criticizing the tax on the basis that it would disproportionately affect "manufacturers,"<sup>28</sup> but these claims are highly misleading. The definition of "manufacturing" includes not only traditional domestic manufacturers, like auto makers, but also companies such as global pharmaceutical and tech firms that shift much of their large profits overseas to tax shelters, contributing to their low effective tax rates. And these types of companies — big pharma, tech companies, and chemical companies, along with apparel companies that produce little in the U.S. — are projected to account for about a quarter of the revenue from the corporate minimum tax, or about half of the revenue in the "manufacturing" category, according to JCT.<sup>29</sup>

Moreover, the large, profitable companies that would face the minimum tax derive considerable benefit from the federal government. They benefit greatly from the spillover effects of government-funded research and technology development, with huge contributions by, for instance, the National Science Foundation and National Institutes of Health. Private companies also benefit from public investments in infrastructure, education, public health, and a clean environment — and a host of other areas that help workers, communities, and companies thrive. Asking corporations that gain so much from public investments to pay a modest, minimum tax rate of 15 percent is entirely reasonable.

While the corporate minimum tax provision is sound, there are a number of key corporate tax reforms missing from the Senate bill. Most importantly, though its minimum tax applies to a corporation's total global profits and therefore would reduce the benefits of shifting profits to overseas tax havens, the bill leaves out several crucial international tax reforms that the House

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<sup>25</sup> Estimated Budget Effects, *op. cit.*

<sup>26</sup> U.S. Department of the Treasury, "Statement from Former Treasury Secretaries on Inflation Reduction Act," August 3, 2022, <https://home.treasury.gov/news/press-releases/jy0912>.

<sup>27</sup> Paul Krugman, August 2, 2022, 1:30 p.m., <https://twitter.com/paulkrugman/status/1554519944246722562>.

<sup>28</sup> Steve Wamhoff, "Opponents of Inflation Reduction Act Call for Continued Tax Avoidance by Large Manufacturers," Institute on Taxation and Economic Policy, August 2, 2022, <https://itep.org/opponents-of-inflation-reduction-act-call-for-continued-tax-avoidance-by-large-manufacturers/>.

<sup>29</sup> JCT, letter to Senator Ron Wyden, August 1, 2022, <https://www.finance.senate.gov/imo/media/doc/CAMT%20JCT%20Data.pdf>.

passed last year as part of its reconciliation package.<sup>30</sup> For instance, the House bill would require multinationals to pay at least a 15 percent tax rate in each country in which they operate instead of on an aggregate basis, preventing them from avoiding the tax by “blending” their taxes and income in low- and high-tax countries. This and other changes would also more closely align the U.S. tax system with the groundbreaking international agreement the Biden Administration has negotiated to tamp down on international tax avoidance. Policymakers should look to include these other reforms from the House bill in future tax legislation.

## **Narrowing Carried Interest Loophole**

The Senate bill would narrow a long-standing loophole that allows managers of private equity funds and other investment funds to pay lower tax rates on their compensation than wage and salary earners do.

Instead of a salary, fund managers typically receive a 20 percent share of the fund’s profit (known as “carried interest”) as compensation for their work managing fund assets. Though carried interest represents payment for services rendered and thus is economically similar to a salary, it is typically taxed at the lower capital gains rate of 20 percent; that’s because investment funds are usually structured as pass-through businesses (meaning their profits are taxed on the owners’ returns rather than through the corporate income tax) and the profits usually consist of capital gains from selling companies’ stock. Since carried interest is economically similar to wages and salaries, a number of tax policy experts have proposed to tax it as ordinary income, not capital gains.<sup>31</sup>

The 2017 tax law took a small step toward limiting the loophole by requiring fund managers to hold their fund investments for more than three years to qualify for the lower capital gains rate on their carried interest; otherwise, they pay the ordinary income rates that apply to wages and salaries.

The Senate bill would build on the 2017 change by increasing the three-year holding period to five years. Private equity funds tend to hold stock in the companies in their portfolio companies for longer than three years, most often five to seven years, so more investment fund managers would pay ordinary income tax rates on their compensation. It’s a modest but meaningful step toward greater equity in the tax code.

## **Economic Impact Would Be Modest But Positive**

The bill would represent a major policy success. Indeed, its primary effects would be on the policy side: it would make the tax system fairer and prescription drugs more affordable, reallocate resources to address climate change, make Affordable Care Act marketplace coverage more affordable, and reduce deficits. While the bill’s macroeconomic impact would be limited, it would neither hurt growth nor stoke inflation, contrary to claims by critics. Amid solid job growth and low unemployment, the Federal Reserve has been tightening monetary policy, including by raising interest rates sharply. The bill would not hinder — and could help — the Fed’s efforts to reduce inflation without triggering a severe recession and large job losses.

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<sup>30</sup> Jacoby, *op. cit.*

<sup>31</sup> See Steven M. Rosenthal, “Taxing Private Equity Funds as Corporate ‘Developers,’” *Tax Notes*, January 21, 2013, <https://www.taxpolicycenter.org/publications/taxing-private-equity-funds-corporate-developers/full>; Victor Fleischer, “Two and Twenty Revisited: Taxing Carried Interest as Ordinary Income Through Executive Action Instead of Legislation,” September 18, 2015, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2661623](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2661623).

While the bill's effects on inflation would likely be modest, leading economists conclude that it would work in the right direction. Jason Furman, former chair of President Obama's Council of Economic Advisers, writes that the Inflation Reduction Act:

is what the country needs now. It will help address one of the world's biggest long-run challenges, climate change, while making progress on inflation. At the same time it will help protect the most vulnerable by extending tax credits for healthcare. . . . Deficit reduction is almost always inflation-reducing.<sup>32</sup>

Similarly, economists at Moody's Analytics write: "Broadly, the legislation will nudge the economy and inflation in the right direction, while meaningfully addressing climate change and reducing the government's budget deficits."<sup>33</sup> While a report from the Penn-Wharton Budget Model found that "The Act would very slightly increase inflation until 2024 and decrease inflation thereafter," it also explained, "These point estimates are statistically indistinguishable from zero, thereby indicating low confidence that the legislation will have any impact on inflation."<sup>34</sup>

The bill's revenue measures restore some fairness to the tax code and would not have a negative impact on jobs and investment. The large corporate tax cuts enacted in 2017 failed to deliver the significant gains in output and wages that proponents had promised;<sup>35</sup> likewise, dire predictions about negative effects from these revenue measures aren't credible. As Moody's concluded: "The corporate tax increases in the Inflation Reduction Act should not have an appreciable impact on the economy, especially given that the effective corporate tax rate has steadily declined for decades and is close to a record low."<sup>36</sup>

The bill's energy-related investments would have a positive impact on the economy over time, helping the nation transition to producing and consuming cleaner energy. And the provisions making prescription drugs and marketplace health coverage more affordable would lower costs that strain families' budgets while also ensuring that more people choose to purchase health coverage and the drugs they need. The bottom line is that, contrary to claims by some critics, the Senate bill is a sound package that would deliver important short- and long-term gains for the country.

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<sup>32</sup> Jason Furman, "The Schumer-Manchin Bill Will Ease Inflation and Climate Change," *Wall Street Journal*, July 28, 2022, <https://www.wsj.com/articles/the-manchin-schumer-bill-will-ease-inflation-and-climate-change-reduction-act-tax-increases-credits-health-insurance-deficit-investment-11659029296>.

<sup>33</sup> Mark Zandi, Bernard Yaros, and Chris Lafakis, "Assessing the Macroeconomic Consequences of the Inflation Reduction Act of 2022," Moody's Analytics, August 2022, <https://bit.ly/3Bxnp5j>.

<sup>34</sup> Penn Wharton Budget Model, "Inflation Reduction Act: Preliminary Estimates of Budgetary and Macroeconomic Effects," July 29, 2022, <https://budgetmodel.wharton.upenn.edu/issues/2022/7/29/inflation-reduction-act-preliminary-estimates>.

<sup>35</sup> Gale and Haldeman, *op. cit.*

<sup>36</sup> Zandi, Yaros, and Lafakis, *op. cit.*