FIVE TAX LOOPHOLES THAT CONGRESS SHOULD CLOSE

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Introduction

The federal tax code is riddled with provisions that benefit individuals and businesses working in certain sectors or engaging in specific activities. In 2019, these provisions — known as tax expenditures — cost the federal government 6.6% of gross domestic product (GDP) in lost revenue, which is greater than the amounts spent on Social Security (4.9% of GDP), Medicare (3.7%), national defense (3.2%), and the entire nondefense discretionary budget (3.1%). Although some tax expenditures help working-class people, 24.1% of their overall benefits go to the top 1% of income-earners, and 58.8% go to the top 20%. The regressive and economically inefficient nature of tax expenditures makes them a ripe target for progressive reform.

This isn’t to suggest that every expenditure helps special interests. For example, the earned income tax credit subsidizes the wages of low-paid workers and pulls four million Americans out of poverty every year. But according to the U.S. Treasury Department, the tax code is littered with over 160 expenditures, including highly regressive expenditures such as the mortgage interest deduction, the state and local tax deduction, the carried interest loophole, and the pass-through business loophole. These carveouts leave the federal government with a Swiss cheese tax code — one that fulfills its basic purpose but is littered with holes. Just as PPI has advocated a regulatory improvement commission to streamline economic regulations, the U.S. also needs to examine the many cracks and holes in the federal tax code.

A few large tax expenditures are already well-known. But most are quite small, and they survive largely by remaining out of sight and out of mind. They also sometimes benefit from lobbying efforts by well-connected industry leaders who prefer that their pet carveouts remain free from public scrutiny. This post, therefore, sheds light on five smaller tax expenditures — the types that don’t normally make the headlines — which ought to be eliminated to boost federal revenues and remove unfair loopholes. Specifically, Congress should:

1. Eliminate the percentage depletion deduction for certain fossil fuel producers;
2. Tax employee awards under either the personal income tax or the corporate profits tax;

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3. Remove the special deduction for Blue Cross Blue Shield and certain other health insurance providers;

4. Eliminate the 5010 credit for wine and flavor additives in distilled spirits; and

5. Remove automatic partnership classification for companies that derive 90% or more of their income from fossil fuels and other depletable natural resources.

These five changes, if enacted by themselves, would raise just under $31 billion over 10 years. But more importantly, these five arcane loopholes are just the tip of the iceberg — policymakers who are willing to take a deeper dive into the tax code will find even greater savings hidden under the surface.

1. Percentage Depletion for Oil, Coal, Gas, and Certain Other Producers ($16.5 billion)

Businesses are supposed to be taxed on their profits, which are equivalent to their revenues minus their expenses. Yet calculating expenses for investments with multi-year returns is somewhat complicated. Under the corporate profits tax, businesses claim annualized depreciation costs for such investments. For example, if a business buys a large number of computers for $100,000, and those computers are expected to break down after five years, the business will record $20,000 of expenses on its tax form every year for five years.

Oil, coal, and gas producers record their investment expenses under an analogous system known as cost depletion. However, if they wish, independent producers and royalty owners can instead use percentage depletion. Under percentage depletion, business owners can claim a certain share of their revenues (not their costs) as a deductible expense. For example, owners of oil and gas wells can claim 15% of their gross revenues as an expense if they sell fewer than 1,000 barrels per day. There are limits on just how much can be deducted, but those limits are lax: Under current law, percentage depletion is capped at 100% of the net income generated by producers’ oil and gas sales. (The limits are somewhat stricter for coal producers.) Percentage depletion was enacted in 1926 as a more generous, less bureaucratic replacement for “discovery depletion,” which had itself been enacted just eight years earlier. Discovery depletion was meant to bolster a fledgling national resources industry that had proved vital during World War I. Throughout the more peaceful decades of the 1960s, ’70s, and ’80s, Congress restricted the use of percentage depletion in numerous ways, but a reduced version of the deduction remains on the books to this day.

As the Progressive Policy Institute (PPI), the Urban-Brookings Tax Policy Center (TPC), and the American Enterprise Institute have pointed out, there are real problems with both cost depletion
and depreciation. PPI has previously called for full expensing of business investments, which means that the full value of investments would be deducted as they are made. This would lower the effective tax rate on new investments, leading to both higher investment and faster growth.

But the problems with cost depletion do not mean that percentage depletion is any better. Percentage depletion gets the relationship between profits and costs completely backwards: When producers’ gross revenues go up (resulting in higher profits), they actually deduct higher expenses. Furthermore, as the Treasury Department has noted, “percentage depletion deductions can exceed the cost of the [initial] investment” — meaning that taxpayers directly subsidize some fossil fuel producers. Finally, percentage depletion is only available to oil, coal, and gas producers, plus a small number of nonfuel mineral producers, meaning that the tax code favors these industries over others.

In its most recent budget proposal, the Biden administration has called on Congress to eliminate percentage depletion for oil, gas, coal, and “other hard-mineral fossil-fuel properties.” According to the Treasury Department, percentage depletion will lose $16.5 billion of revenue between fiscal years (FYs) 2023 and 2032. By eliminating percentage depletion, Congress can raise revenue, better align companies’ profits with their costs, and set a more level playing field between different industries.

2. Deduction for Employee Awards ($5.9 billion)

A few specific types of employee awards — including plaques, rings, and watches for workplace safety or length of service — are exempt from taxation. The awards’ nontaxable value is capped at $1,600 if they are part of a written contract and at $400 otherwise. Workers can receive untaxed length-of-service awards at most once every five years and cannot receive them before the end of their fifth year.

The rationale for taxing these awards is that they are similar to wages. In principle, giving a worker a $1,000 watch is no different than giving them $1,000 of cash and letting them buy a watch. There is no good reason for taxing the latter while exempting the former.

The regulations surrounding nontaxable awards protect against basic abuse. Awards such as gift cards, sports tickets, and meals are taxable because they look strikingly similar to direct cash payments. On the other hand, a watch or other item costing up to $1,600 can still be quite luxurious.

The IRS also requires that nontaxable awards from written contracts be given out “as part of an established … plan or program that doesn’t favor highly compensated employees,” yet the progressivepolicy.org
agency’s definition of “highly compensated” is extremely broad. Workers are not considered “highly compensated” until they make at least $130,000 — meaning that an individual can out-earn 92% of his fellow countrymen and still evade taxes on his award. But it gets worse: The IRS allows companies to go above even the $130,000 threshold so long as the worker is not in the top 20% of his own firm’s wage distribution — meaning that firms with many high-wage workers, such as hedge funds and investment banks, can give untaxed awards to workers in even the top 1% of the national wage distribution.

If these awards are thought of like wages, they should be subject to income and payroll taxes; if they are more akin to profit-sharing with employees, they should be subject to the corporate profits tax. The status quo, in which they are subject to neither tax, lacks a coherent rationale.

In December 2022, the Joint Committee on Taxation (JCT) estimated that this expenditure will cost $2.4 billion between FYs 2022 and 2026. After adjusting the JCT’s estimates for nominal GDP growth and extending them over a ten-year time horizon, PPI estimates that the nontaxation of certain employee awards will cost $5.9 billion between FYs 2023 and 2032.

3. Special Deduction for Blue Cross Blue Shield and Certain Other Health Insurance Providers ($4.7 billion)

For most of the 20th century, Blue Cross Blue Shield (BCBS) was exempt from federal taxation due to its status as a nonprofit insurer. In 1986, Congress revoked BCBS’ tax-exempt status, but as a compromise measure, it gave a special deduction to BCBS and a few similar organizations. Unlike virtually any other part of the tax code, this deduction targets an individual organization for preferential treatment. Tax code section 833 lists BCBS by name, and to this day, the section is still titled “Treatment of Blue Cross and Blue Shield organizations, etc.”

When paying their taxes, other insurance companies can deduct 20% of their unpaid premium reserves (UPRs) from their income. UPRs are payments for future insurance coverage. For example, if someone purchases a $5,000 health insurance plan in November 2023, which will give them coverage in 2024, the insurance company records $5,000 of UPR income for 2023. The unique tax status of UPRs exists partially to account for the timing imbalance between when a company receives premium payments and when it covers its clients’ medical bills; it is also attributable to the fact that UPRs are not a guaranteed source of income, as companies are required to return UPRs to customers who cancel their policies.

The BCBS deduction is more complicated, but in simple terms, it allows BCBS companies to deduct 25% of their expenses minus their beginning-of-the-year assets. If a BCBS company begins the year with $6 million of assets and incurs $40 million of expenses, then its total
The 2010 Affordable Care Act (ACA) added a requirement that for BCBS companies to receive the deduction, they would have to dedicate at least 85% of their spending to medical care rather than overhead costs (such as profits, worker pay, etcetera). This reflects what Johns Hopkins Professor Steven Teles has called kludgeocracy: the tendency among policymakers to complicate the tax code by adding benign regulations rather than repealing harmful ones. But beyond that, it isn’t even clear whether the share of insurance spending going to medical care — referred to as the Medical Loss Ratio, or MLR — is a useful metric. The MLR is not a measure of overall healthcare costs, but rather of how those costs are distributed. Indeed, a 1997 article in Health Affairs noted that MLRs tend to be higher among insurers charging steeper premiums. Paradoxically, insurers that are worse at bargaining down medical prices will have higher MLRs (and will appear “more efficient”) simply because medical spending will constitute a larger share of their customers’ premiums.

According to the Treasury Department, the BCBS deduction will cost nearly $4.7 billion over the next decade. This is an unjustified giveaway for a small handful of insurance companies, and even with the new MLR provisions in place, it is hard to defend this deduction.

4. The 5010 Credit for Wine and Flavor Additives in Distilled Spirits ($2.7 billion)

The federal government raises a little over $10.7 billion each year from a complicated series of excise taxes on different types of alcohol. For many years, tax rates have been different for beer, hard cider, still wine, artificially carbonated wine, sparkling wine, and distilled spirits, as well as for large versus small producers. Also, there are tax preferences that can be complex and arbitrary and create problematic distortions in the beverage market.

For example, section 5010 of the Internal Revenue Code allows liquor producers to claim a special credit if they mix their spirits with flavor or wine additives. Although it makes sense in theory for distilled spirit producers to pay the lower wine tax rates on the wine portions of their drinks, enforcement is impractical and distillers often include questionable additives such as “other than standard wine” and “alcoholic flavoring” simply to reduce their tax liability. The 5010 deduction also allows them to exempt 2.5% of their drinks’ alcohol content from taxation for no clear reason whatsoever.

The credit can become so substantial that it encourages companies to prioritize unpopular, tax-subsidized drinks over popular, unsubsidized ones. A report from the Congressional Research Service notes that: “Materials to produce a drink with 50% wine content cost three
times more [before taxes] than a drink with only distilled spirits; however, the total cost is 32% ($1.74) less because of the tax savings.” As former Montana Senator Max Baucus noted in a recent op-ed, this results in a greater supply of “cherry vodka and orange maple whiskey” — not exactly the country’s most beloved drinks.

However, there are two deeper problems with the 5010 credit. First, it is extremely difficult for the government to administer. Producers have a strong incentive to exaggerate the wine share of any given drink; and while the government can ascertain a drink’s chemical ingredients, it can’t necessarily tell where those ingredients came from. A 1990 report from the Government Accountability Office (GAO) described how difficult it is for regulators to determine which shares of a drink come from liquor versus wine versus additives:

“First, laboratory tests, while sufficiently detailed to examine parts per billion of each ingredient, cannot determine the source of the alcohol contained in the beverage. Therefore, a thorough inspection of the company’s records is required to determine exactly what ingredients were used to make the product.

Second, inspecting the records of companies claiming this tax credit can be relatively complex and time-consuming in comparison with other alcohol inspections because the inspectors must trace the sources of all alcohol used in each beverage. Distilled spirits plants may produce several different beverages, each taxed at different effective rates, and may also change the products’ formulas. A [regulatory] official said that it is difficult for inspectors to determine whether the correct amount of tax was paid in each instance.”

The GAO ultimately concluded: “The current [alcohol] excise tax rates were developed on an ad hoc basis over the years and do not reflect … ease of administration.”

These enforcement issues lead to a second serious problem. The U.S. government cannot audit businesses in other countries, so foreign producers can exaggerate their credits even more than domestic producers can. Less than one third of distilled spirits are imported, yet according to Senator Baucus, “[t]he credit is primarily used by large foreign liquor manufacturers.”

Because the 5010 credit is poorly designed, difficult to enforce, and favorable to foreign producers, the Obama administration rightly called for its repeal on four separate occasions — in its 2014, 2015, 2016, and 2017 budget proposals. In March 2016, the Joint Committee on Taxation estimated that the 5010 credit would cost $1.9 billion over 10 years. Assuming the revenue losses from the credit remain constant as a share of GDP, this would translate to $2.7
billion of foregone revenue between FY 2023 and FY 2032.

5. Master Limited Partnership Classification for Companies that Derive 90% or More of their Income from Depletable Natural Resources ($1.0 billion)

There are many classifications for different types of businesses in the U.S., with two of the most common being corporations and partnerships. Income earned by corporations is subject to the corporate profits tax, whereas partnership income goes directly to the “partners” who own or operate the firm. These partners then pay individual income taxes on their partnership income.

Until the 1980s, the top tax rate on individual income had been higher than the tax rate on corporate income, so investors typically preferred to be taxed at the business level rather than at the individual level. However, after a series of tax cuts passed by Congress and signed by President Reagan, it became preferable to avoid business-level taxes and instead be taxed on personal income directly. This gave rise to business partnerships, which allowed investors to avoid corporate profits taxes and have all partnership income be taxed at the individual level.

The Treasury Department then lobbied Congress to limit the use of partnerships because their growth was eroding the corporate tax base. Yet as with Congress’ 1986 reforms to the BCBS loophole, its partnership reforms (enacted in 1987) shrunk the partnership loophole instead of closing it. Under current law, companies that derive at least 90% of their revenues from “depletable natural resources, real estate, or commodities” can be publicly traded like corporations (giving them increased liquidity and greater access to capital) without having to pay the corporate profits tax. Such companies are classified as Master Limited Partnerships, or MLPs.

This special tax exemption is hard to justify. As lawyer David Powers explains, MLPs are generally not passive entities — they are more like “corporations in disguise.” The designation has also been applied to an unnecessarily wide swath of companies, including businesses that merely provide equipment to the natural resources industry.

In a 2013 New York Times column, law professor Victor Fleischer argued that the MLP designation has proved harmful to both taxpayers and the environment. “As more M.L.P.’s come to resemble normal operating companies, the tax loophole looks more like a straightforward tax subsidy for fossil fuel production,” he wrote. “From an environmental standpoint, this is exactly backward. We should be taxing carbon production, not subsidizing it.”

Both the Obama and Biden administrations have proposed that publicly traded fossil fuel companies begin paying the corporate profits tax. According to the Biden administration, this

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change would raise about $1.0 billion from FY 2023 to FY 2032.

**Conclusion: A Starting Point for Cleaning Up the Tax Code**

As these five tax expenditures demonstrate, the federal tax code is littered with small expenditures for special interests, favored industries, and even harmful economic activities. By themselves, these five expenditures will only cost $30.8 billion over the coming decade. However, if lawmakers are willing to clean up the tax code more broadly, trillions of dollars are potentially on the table. These loopholes and tax preferences shouldn’t escape scrutiny just because they are baked into the status quo.

**About the Author**

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