



TAX ALERT

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House Votes to Extend Tax Breaks

Yesterday, the House voted 241-181 to extend income tax deductions and credits which will reduce revenue by \$31 billion. These deductions and credits are scheduled to expire December 31, 2009. The legislation includes the research and development credit, a tax deduction which benefits taxpayers who live in states that do not have a state income tax and a property tax deduction intended to benefit taxpayers who cannot itemize their deductions.

The bill also provides for tax increases to offset the revenue lost as a result of the extension of the tax credits and deductions. Only two Republicans voted in favor of the legislation. Most Republicans voted against it because they are against one of the tax increases in the bill. The tax increases arise as follows:

1. a crackdown on international tax evasion (\$7.7 billion) and
2. taxing carried interest as ordinary income (\$24.6 billion).

International Tax Evasion

The legislation imposes new reporting requirements for foreign financial institutions doing business in the U.S. Foreign firms face a 30% withholding tax if they fail to comply. This provision represents a continuation of legislation and regulations aimed at stopping taxpayers from hiding assets abroad.

Carried Interest

Investment managers typically get a fee to manage assets. They also receive a share of the profits earned above a certain level. This share of the profits is known as carried interest. While the fee to manage the assets is taxable as ordinary income, the carried interest is taxable as a capital gain. Long-term capital gains are taxed at a maximum rate of 15% while ordinary income is taxed at a maximum rate of 35% (scheduled to increase to 39.6% in 2011).

President Obama, the Democrats and the Republicans agree with the crackdown on international tax evasion. While President Obama and the House Democrats want the carried interest to be taxed as ordinary income, most Republican congressmen want the carried interest to continue to be taxed as a capital gain. The House Democrats argue that Wall Street financiers should not be taxed at a lower rate than employees making less money.

House Republicans argue that increasing the tax on carried interest would discourage investment. They argue that increasing taxes on growth investments does not make sense during a fragile economic recovery. Real estate organizations argue that the tax increase caused by taxing carried interest as ordinary income would hurt real estate partnerships, further eroding property values.

There promises to be a battle in the Senate between these two conflicting positions because a substantial number of Senators from both parties are against taxing carried interest as ordinary income.