# Tax Proposals in the 2012 Budget

Tax Policy Center
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The Tax Policy Center offers the table below as a guide to the tax provisions of President Obama's 2012 budget. Subsequent pages provide detailed descriptions and brief commentaries on each provision. Linked tables show the distributional effects of the overall proposal and of major elements of the plan. Further details on the analysis appear on the next page.

View Distribution Tables

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Tax Proposals

| Provisions Affecting Only Highest Income Taxpayers * | |
|---|---|
| Allow 2001-03 Tax Cuts to Expire and Tax Qualified Dividends like Long-Term Capital Gains | |
| Allow top two rates to rise to 36% and 39.6% after 2012 | Allow the personal exemption phaseout (PEP) and limitation on itemized deductions (Pease) to return after 2012 |
| Tax net long-term capital gains at a 20% rate | Tax qualified dividends at a 20% rate |
| Limit the value of itemized deductions to 28 percent | |
| **Other Major Provisions Affecting Individual Taxpayers** | |
| Extend the 2001 and 2003 tax cuts for taxpayers at incomes below certain thresholds | Index to inflation the 2011 parameters of the individual alternative minimum tax |
| Tax carried interest as ordinary income | Expand the child and dependent care tax credit |
| Extend the earned income tax credit for larger families | Extend the American Opportunity tax credit |
| Require automatic enrollment in IRAs and enhanced small employer startup credit | Extend 2009 estate and gift tax parameters and other estate tax reforms |
| **Business Tax Provisions** | |
| **Business Tax Incentives** | **Business Tax Increases and Elimination of Preferences** |
| Make the research and experimentation credit permanent | Eliminate fossil fuel tax preferences |
| Increase credits for energy-efficient investments | Impose a financial crisis responsibility fee |
| Provide new tax incentives for regional growth | Reform international taxation rules |
| Eliminate taxation of capital gains on qualified small business stock | Reform treatment of insurance companies and products |
| | Revise tax treatment of inventories |
| **Other Revenue Proposals** | |
| Reinstate superfund taxes | Extend certain expiring provisions through 2012 |
| Expand the Federal Unemployment Tax Act (FUTA) base and make the UI surtax permanent | Expand surface transportation funding |
| | Other revenue proposals |

* The president would increase individual income taxes only for individuals with adjusted gross income over $200,000 and couples with AGI over $250,000 (2009 values, adjusted for inflation).

Descriptions of tax provisions and revenue estimates come from Department of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, February 2011. The Joint Committee on Taxation has also published cost estimates in Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal.

The Tax Policy Center has posted a variety of tables showing the distributional effects of the entire set of tax proposals, all individual tax proposals, and selected specific proposals. Click here for a linked guide to those tables.

The administration assumes a baseline that permanently extends the 2001–03 tax cuts for all but the highest income taxpayers,[1] makes the estate tax permanent with 2009 parameters, and indexes the parameters for the alternative minimum tax (AMT) from their 2011 levels.

This analysis does not use the administration's baseline. Most of our distribution tables compare the effects of tax proposals separately against both a current law baseline and a current policy baseline. The former assumes that the 2001–03 tax cuts expire in 2013 as scheduled (including changes in the estate tax) and that the AMT exemption reverts to its permanent value after 2011. Our current policy baseline assumes extension of all temporary provisions in place for calendar year 2011 except the payroll tax cut. In particular, it indexes the 2011 AMT exemption level for future years, makes the 2001 and 2003 individual income tax cuts permanent, extends certain provisions in the 2009 stimulus bill,[2] makes 2011–12 estate tax law permanent with a $5 million exemption and 35 percent tax rate, and continues expiring tax provisions that Congress has regularly extended.

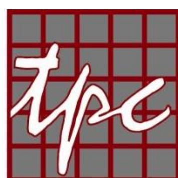
For each tax proposal, a separate web page describes current law, the proposed change, and its distributional effects. We do not consider the long-term effects on the economy.

Because some of the tax proposals are not indexed for inflation, their real effects would change over time. The value of most unindexed proposals would decline in real terms, either because their values are fixed in nominal dollar amounts or because nominal phaseout thresholds would affect more taxpayers. A more complete discussion of the impact of indexing appears at the end of this document.

TPC will update this analysis as the budget moves through Congress.

[1] Individuals with adjusted gross income (AGI) over $200,000 and couples with AGI over $250,000, both 2009 values indexed for inflation.

[2] The current policy baseline assumes extension of three stimulus provisions: expansion of the earned income tax credit (EITC), increased refundability of the child tax credit, and the American Opportunity tax credit.

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# Tax Proposals in the 2012 Budget*

ERIC TODER　DONALD MARRON　ROBERTON WILLIAMS　BEN HARRIS
ELAINE MAAG　JIM NUNNS　JOSEPH ROSENBERG　KIM RUEBEN

## Introduction

The Tax Policy Center has examined the key tax proposals in President Obama's 2012 budget. Separate discussions below describe each of the proposals including current law, proposed changes, and, when appropriate, the distributional effects. The budget as presented by the president lacks complete details on many of the tax proposals. Some provisions had virtually no detail, and our discussion of them is necessarily limited.

The budget assumes a baseline in which the 2001–03 tax cuts are permanently extended for single people with income under $200,000 and couples with income under $250,000, the estate tax permanently reverts to its 2009 level, and parameters for the alternative minimum tax (AMT) are permanently indexed for inflation from their 2011 levels. Those provisions would reduce revenues by $3.1 trillion from 2012 through 2021 (table 1).

**Table 1. The Budget Impacts of the President's Tax Policies, 2012 - 2021**

| Positive figures indicate smaller deficits | $ Trillions |
|---|---|
| Changes to Current Law assumed in the president's baseline[a] | -3.1 |
| Changes to Current Law proposed in the president's budget[b] | 0.7 |
| Budget impact of the president's policies versus Current Law[c] | -2.4 |
| Memo: Budget impact of the president's policies versus Current Policy[d] | 2.0 |

Notes:
a. This figure reflects a $2,845 billion revenue decrease and a $226 billion outlay increase.
b. This figure reflects a $819 billion revenue increase and a $115 billion outlay increase.
c. This figure reflects a $2,026 revenue decrease and a $341 billion outlay increase.
d. Estimated. Under current law, many temporary tax cuts expire in coming years. Current policy assumes all are permanently extended except the 2011 payroll tax holiday and temporary investment incentives. See Table 3.

* The authors thank Jeff Rohaly, Rachel Johnson, Dan Baneman, and Ritadhi Chakravarti for their modeling efforts.

Relative to that baseline, the president's proposals would raise an additional $700 billion in revenue over the coming decade. That revenue gain is composed of two kinds of tax change: about $400 billion in revenue lost to a variety of tax reductions and $1.1 trillion in added revenue from tax increases (table 2). About a third of the revenue loss would come from taxing qualified dividends at 20 percent (rather than at the higher rates on ordinary income) for high-income taxpayers; another third would result from making permanent provisions in the 2009 stimulus act mostly for low- and middle-income households; and a third would be due to various business tax cuts primarily affecting smaller firms. On the revenue-increase side, about 30 percent of additional revenues would come from limiting the value of itemized deductions to 28 percent (affecting only high-income taxpayers), about 30 percent from unspecified sources to fund surface transportation projects, and the balance from a potpourri of provisions mainly affecting businesses.

TPC's analysis measures the impact of the tax proposals not against the administration baseline but rather against a current law baseline that assumes the 2001–03 tax cuts expire as scheduled in 2011 and that the AMT exemption

**Table 2. The President's Tax Policies, 2012 - 2021**

| Positive figures indicate smaller deficits | $ Billions |
|---|---|
| CHANGES TO CURRENT LAW ASSUMED IN THE PRESIDENT'S BASELINE | |
| Extend AMT patch beyond 2011 (index 2011 parameters to inflation) | -1,550 |
| Extend 2001 and 2003 tax cuts for "middle-income" taxpayers beyond 2012 | -1,250 |
| Extend estate and gift taxes at 2009 parameters beyond 2012 | -271 |
| Total, changes assumed in president's baseline | -3,071 |
| | |
| CHANGES TO CURRENT LAW PROPOSED IN THE PRESIDENT'S BUDGET | |
| Individual income tax reductions | |
| Tax dividends and long-term capital gains at 20% for "upper incomes" | -124 |
| Extend American Opportunity Tax Credit | -94 |
| Provide automatic enrollment in IRAs and related provisions | -14 |
| Extend EITC for larger families | -12 |
| Expand child and dependent care tax credit | -10 |
| Business income tax reductions | |
| Expand and make permanent the R&E tax credit | -106 |
| Eliminate capital gains taxation on some small business stock | -5 |
| Expand credits for select energy investments | -5 |
| Other tax reductions | |
| Extend certain expiring tax provisions through 2012 | -22 |
| Repeal and modify information reporting | -9 |
| Promote international trade | -7 |
| Provide new incentives for regional growth | -7 |
| Subtotal, tax reductions | -416 |
| Limit itemized deductions for "upper-income" taxpayers | 321 |
| Business income tax increases | |
| Increase taxation of international income | 129 |
| Repeal LIFO accounting for inventories | 53 |
| Eliminate fossil fuel tax preferences | 46 |
| Increase taxes on financial institutions and products | 33 |
| Tax carried interest as ordinary income | 15 |
| Increase taxes on insurance institutions and products | 14 |
| Other business income tax increases | 9 |
| Modify estate and gift tax valuation and rules | 20 |
| Program integrity initiatives, compliance, and administration | 67 |
| Other tax provisions | |
| Increase unemployment insurance taxes | 60 |
| Reinstate Superfund taxes | 21 |
| Other tax provisions | 3 |
| New funding for surface transportation, details not specified | 328 |
| Subtotal, tax increases | 1,119 |
| Total, changes proposed in president's budget | 703 |

Note: These figures combine revenue and outlay effects.

maintains its permanent level.[3] In contrast to the administration's estimate that the president's tax proposals would yield $700 billion in added revenue over ten years, measured against our current law baseline, the proposals would lose about $2.4 trillion of revenue over the 2011–21 period.

Many observers assert that using a current law baseline to measure revenue change is unrealistic since few people believe that Congress and the president would allow complete expiration of the 2001–03 tax cuts or the permanent law AMT to take effect. They argue that measuring policy proposals against a current policy baseline that assumes the tax law in effect this year provides a more realistic assessment of their impact on federal revenues. Relative to that baseline, TPC estimates that the president's proposals would raise an additional $2 trillion over the coming decade (table 3). About half of that amount would come from tax increases on high-income taxpayers, higher estate taxes, and allowing some temporary tax provisions to expire as scheduled. The other half of the revenue gain would result from proposals that are not part of this year's tax law.

Table 3. Comparing the President's Tax Policies to Current Policy, 2012-2021

| Positive figures indicate smaller deficits | $ Billions[a] |
|---|---|
| Current policies the president does not include: | |
| "Upper-income" 2001 and 2003 tax cuts (beyond 2012) | 709 |
| Estate and gift taxes at 2011 indexed parameters (beyond 2012) | 98 |
| Certain expiring tax provisions (beyond 2012)[b] | 224 |
| President's proposals that are not in current policy | 1,081 |
| Adjustment for interactions[c] | -135 |
| Total | 1,977 |

Notes:

a. These figures combine revenue and outlay effects.

b. Estimate. The president proposes to extend them through 2012. The estimate assumes their value grows with GDP.

c. Estimate. This figure accounts for the interaction between the "upper-income" tax cuts and the proposal to limit itemized deductions.

A collection of distributional tables shows how the president's tax proposals would affect taxpayers at different income levels, relative to both current law and current policy baselines. Detailed tables examine individual proposals and combinations of proposals. Note that the distributional effects of the proposals would change over time because most of them are not indexed for inflation. As a result, some of the proposed tax cuts would benefit fewer taxpayers in future years, and the value of some of the cuts would shrink. Even provisions that are indexed for inflation would affect more or fewer taxpayers over time because of changes in real income.

Relative to current law, the entire package of proposals would reduce taxes in 2013 for about three-quarters of all households and raise taxes for about 6 percent (see table). People at both ends of the income distribution would be least likely to see their taxes go down: only about 40 percent of those in the bottom quintile (20 percent of tax units) and half of those in the top 1 percent would see their taxes go down. At the same time, half of those in the top 1 percent would face a tax increase, compared with less than 2 percent of those in the next-to-top quintile (60th through 80th percentiles). On average, taxes would drop an average of nearly $1,700 in 2013. Among income groups, only the top 1 percent would see an average tax increase—just over $800.

[3] Congress has repeatedly "patched" the AMT by increasing its exemption for one-year periods. Our current law baseline assumes no such patches in future years.

The story is quite different measured against a current policy baseline that is essentially the tax law in place for 2011 (see table). Against that baseline, less than a fifth of taxpayers would see their taxes go down in 2013 under the president's proposals while about a third would experience a tax increase. The average federal tax bill would rise nearly $800. People in the lowest income quintile would be least affected—less than a quarter would experience any tax change—while virtually everyone in the top 1 percent (97 percent) would see their taxes go up by an average of nearly $90,000, cutting their average after-tax income by more than 6 percent.

This analysis is preliminary and we will update it as more information becomes available and as the budget works its way through Congress.

### Tax Provisions Affecting Only High-Income Taxpayers

During the 2008 campaign, President Obama promised that he would raise taxes only on households with the highest income—over $250,000 for married couples and over $200,000 for single people. In keeping with that promise, he proposes to increase taxes for those taxpayers by allowing the 2001-03 tax cuts to expire as scheduled in 2013 and limiting the value of itemized deductions to 28 percent. He would continue to tax qualified dividends at the same rate as long-term capital gains. That would represent a tax cut for high-income taxpayers since dividends would otherwise be taxed at the same rates as ordinary income.

Compared against current law, these provisions would affect only 3 percent of households, increasing taxes for just over half of them and cutting taxes for the rest. Taxpayers at the very top of the income distribution would be more likely to face tax increases: among those in the top 1 percent, 72 percent would see their tax bills rise while just 18 percent would save because of the lower tax on their qualified dividends. Relative to current policy with all of the 2001-03 tax cuts in place, the proposals would increase taxes only for 2 percent of households, all in the top income quintile. Nearly 90 percent of those in the top 1 percent would face an average tax increase of more than $80,000, cutting their after-tax income by about 6 percent.

The net two sections discuss in greater detail the president's tax proposals affecting only high-income taxpayers.

### Distribution Tables

Tax increases on high-income taxpayers

- 2013 versus current law by cash income
- 2013 versus current law by cash income percentile
- 2013 versus current policy by cash income
- 2013 versus current policy by cash income percentile

## Allow 2001 and 2003 Tax Cuts to Expire at the Highest Incomes

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) extended the 2001 and 2003 tax cuts through 2012, but nearly all of them are now scheduled to expire in 2013. Unless Congress acts, the individual income tax will return to its pre-2001 level (except for a few permanent changes). In defining the baseline for his budget, the president assumes that, rather than ending in 2013, the tax cuts will become permanent for low- and moderate-income households but would expire at income levels over $250,000 for couples and above $200,000 for single people (both thresholds in 2009 dollars and indexed for inflation in future years). Specifically, at these income levels, the president would

- allow the top two tax rates to revert to their pre-2001 levels of 36 percent and 39.6 percent and create a new tax bracket between the next-to-highest rate and the one immediately below it to prevent a rate increase on income below the thresholds;
- allow reinstatement of the personal exemption phaseout and the limitation on itemized deductions;
- allow the tax rate on long-term capital gains to return to 20 percent for taxpayers in the top two tax brackets; and
- impose a 20 percent tax rate on qualified dividends for taxpayers in the top two tax brackets.

In addition, the president would eliminate a pre-2003 law provision that allowed 8 percent and 18 percent tax rates on capital gains on assets owned more than five years.

Those tax increases would allow marginal tax rates at the highest income levels to return to rates scheduled after 2012 under current law. Those with qualified dividend income would pay less tax because the proposed 20 percent rate would be lower than their regular tax rate, the rate that would apply to dividend income if Congress let the 2001–03 tax cuts expire as scheduled. Others would pay more tax because the 20 percent rate on capital gains exceeds the 18 percent rate that would apply to gains on assets held more than five years and because the phaseout of personal exemptions would begin at a lower income than under current law.

Relative to current law, under which the 2001–03 tax cuts would virtually all expire after 2010, these proposals would reduce income taxes for about 15 percent of all taxpayers with most of the benefit toward the upper end of the income distribution. About half of those in the top quintile and over three-quarters of those in the top 1 percent would experience a tax cut. Compared against current policy with the 2001-03 tax cuts in place, these provisions would increase taxes for one-eighth of households in the top income quintile and nearly 90 percent of those in the top 1 percent. Affected taxpayers in the latter group would see their average tax liability rise by more than $60,000 and their after-tax income fall by nearly 5 percent.

### Distribution Tables

Allow 2001-03 tax cuts to expire for high-income tax units

2013 versus current policy by cash income

2013 versus current policy by cash income percentile

- **Allow top two rates to rise to 36% and 39.6% after 2012**

The president proposes to allow the top tax rate in 2013 to increase from 35 percent to 39.6 percent as scheduled under current law. In 2013, that would increase income tax liability for all taxpayers with taxable income over $390,050 (half that amount for married couples filing separately).

- **Increase the 33 percent tax rate to 36 percent only for joint filers with adjusted gross income over $250,000 ($200,000 for single filers) in 2013.**

The president proposes to allow the 33 percent tax rate to return to its pre-2001 level of 36 percent as scheduled under current law but only for joint filers with adjusted gross income over $250,000 ($200,000 for single filers, with both values in 2009 dollars and indexed for inflation in future years). For married couples filing jointly, the 36 percent bracket would begin when taxable income exceeds $250,000 minus the sum of the standard deduction for couples and the taxpayers' personal exemptions. For single filers, the threshold would start at $200,000 minus the sum of the standard deduction for single filers and the taxpayer's personal exemption.[4] The president would maintain the 33 percent tax rate for income below those thresholds that is currently taxed at 33 percent. Maintaining the 33 percent bracket for taxpayers below the thresholds would represent a tax cut relative to current law under which the tax rate would rise to 36 percent.

**2013 Tax Rates, Standard Deduction, and Personal Exemption under Alternative Baselines and as Proposed in the 2012 Budget**

| Taxable Income: Over | Taxable Income: But not over | Current Law (Bush-Era Tax Cuts Expire) | Administration's FY2012 Budget Proposal | Current Policy (Bush-Era Tax Cuts in Place) |
|---|---|---|---|---|
| **Marginal Tax Rates for Single Individuals** | | | | |
| $0 | $8,750 | 15% | 10% | 10% |
| $8,750 | $35,500 | 15% | 15% | 15% |
| $35,500 | $86,000 | 28% | 25% | 25% |
| $86,000 | $179,400 | 31% | 28% | 28% |
| $179,400 | $199,350 | 36% | 33% | 33% |
| $199,350 | $390,050 | 36% | 36% | 33% |
| $390,050 | — | 39.6% | 39.6% | 35% |
| **Marginal Tax Rates for Married Couples Filing Jointly** | | | | |
| $0 | $17,500 | 15% | 10% | 10% |
| $17,500 | $59,300 | 15% | 15% | 15% |
| $59,300 | $71,000 | 28% | 15% | 15% |
| $71,000 | $143,350 | 28% | 25% | 25% |
| $143,350 | $218,450 | 31% | 28% | 28% |
| $218,450 | $241,900 | 36% | 33% | 33% |
| $241,900 | $390,050 | 36% | 36% | 33% |
| $390,050 | — | 39.6% | 39.6% | 35% |
| **Marginal Tax Rates for Heads of Household** | | | | |
| $0 | $12,500 | 15% | 10% | 10% |
| $12,500 | $47,600 | 15% | 15% | 15% |
| $47,600 | $122,850 | 28% | 25% | 25% |
| $122,850 | $198,900 | 31% | 28% | 28% |
| $198,900 | $222,750 | 36% | 33% | 33% |
| $222,750 | $390,050 | 36% | 36% | 33% |
| $390,050 | — | 39.6% | 39.6% | 35% |
| **Standard Deduction** | | | | |
| Single: | | $5,950 | $5,950 | $5,950 |
| Married Filing Jointly: | | $9,950 | $11,900 | $11,900 |
| Head of Household: | | $8,750 | $8,750 | $8,750 |
| Personal Exemption: | | $3,800 | $3,800 | $3,800 |

Same as Current Law and Current Policy
Reduced relative to Current Law, same as Current Policy
Increased relative to Current Policy, same as Current Law

[4] Tax brackets for heads of household would be set midway between those for single and joint filers; those for married couples filing separately would be half those for joint filers.

- **Reinstate personal exemption phaseout and limitation on itemized deductions**

High-income taxpayers face reductions of their personal exemptions and itemized deductions as their income exceeds specified levels. The 2001 tax act scheduled a gradual phased elimination of the reductions beginning in 2006 with complete elimination in 2010. The 2010 tax act extended the elimination through 2012, after which, under current law, the reductions return at their original levels. The president proposes to allow both reductions to resume in 2013 but only for high-income taxpayers—single filers with AGI over $200,000 and joint filers with AGI over $250,000 (2009 values, indexed for inflation).

In its full form, the personal exemption phaseout (PEP) reduces the value of each personal exemption from its full value by 2 percent for each $2,500 or part thereof above specified income thresholds that depend on filing status. Personal exemptions are thus fully phased out over a $122,500 range (see table).

The limitation on itemized deductions—known as Pease after the congressman who introduced it—cuts itemized deductions by 3 percent of adjusted gross income above specified thresholds but not by more than 80 percent. The income threshold—projected to be $174,450 in 2013 ($87,225 for married couples filing separately)—is indexed for inflation.

The president proposes to allow both PEP and Pease to resume for high-income taxpayers in 2013 but would markedly change the income levels above which the provisions apply. The threshold for the phaseouts would begin at 2009 levels of $250,000 for couples[5] and $200,000 for other taxpayers, with both values indexed for inflation. TPC estimates that 2013 thresholds would be $261,450 for couples, $209,150 for single filers, $235,300 for heads of household, and $130,725 for couples filing separately. Personal exemptions would thus phase out at incomes between $261,450 and $383,950 for joint filers, between $209,150 and $331,650 for single filers, and between $235,300 and $357,800 for heads of household.[6] Taxpayers would have their itemized deductions reduced in 2013 by 3 percent of their income over the same thresholds but not by more than 80 percent. Both phaseouts would increase marginal tax rates for taxpayers in the affected income ranges. The increase would jump irregularly for PEP, depending on the number of exemptions a taxpayer

**Income Ranges for Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease), 2013**

| | Budget Proposal | | Current Law | |
|---|---|---|---|---|
| Filing Status | Starting AGI, Pease and PEP | AGI, Phaseout Complete | Starting AGI, PEP* | AGI, Phaseout Complete |
| Married, filing jointly or surviving spouse | $261,450 | $383,950 | $261,650 | $384,150 |
| Heads of household | $235,300 | $357,800 | $218,050 | $340,550 |
| Single | $209,150 | $331,650 | $174,450 | $296,950 |
| Married, filing separately | $130,725 | $191,975 | $130,825 | $192,075 |

* Under current law, Pease begins at the same income for single, joint, and head of household filers —$174,450 in 2013. For married couples filing separately, the threshold is half that amount.

[5] PEP would start at $125,000 (indexed forward from 2009) for couples filing separately.

[6] The values for married couples filing separately would be half those for joint filers.

claims. Pease would increase the marginal tax rate of affected taxpayers by 3 percent of their bracket rate: 36 percent would go to 37.08 percent, and 39.6 percent would rise to 40.79 percent.

**Additional Resources**

*Tax Policy Briefing Book*: Income Tax Issues: How do phaseouts of tax provisions affect taxpayers?

- **Allow resumption of 20 percent rate on long-term capital gains for high-income taxpayers**

In 2011 and 2012, long-term capital gains (gains on assets held at least a year) face a maximum tax rate of 15 percent. Taxpayers with regular tax rates of 15 percent or less pay no tax on that income. Under current law, tax rates on long-term gains are scheduled to revert in 2013 to their pre-2003 levels of 10 percent for taxpayers in the 15 percent bracket and below and 20 percent for taxpayers in higher tax brackets.[7] The president would also allow the rate to rise to 20 percent starting in 2013, but only for high-income taxpayers. The proposal defines high-income taxpayers as those in the top two tax brackets: couples with 2013 taxable income above $241,900 (half as much for couples filing separately), single filers with income over $199,250, and heads of household with income over $222,750, with all values indexed for inflation.

The higher rate on capital gains could induce taxpayers to hold on to assets with accrued gains and therefore realize fewer taxable gains. If people expect the president's budget to go into effect, they may also change the timing of gains realizations. Anticipation of higher taxation of long-term gains after 2012 would lead affected taxpayers to realize more gains in 2011 and 2012 and fewer in 2013 and subsequent years.

- **Reduce the tax rate on qualified dividends to 20 percent rate for high-income taxpayers**

In 2011 and 2012, qualified dividends face a maximum tax rate of 15 percent. Taxpayers with regular tax rates of 15 percent or less pay no tax on that income. Under current law, qualified dividends will be taxed at regular tax rates in 2013. The president would reduce the tax rate in 2013 to 20 percent for taxpayers in the top two tax brackets—couples with 2013 taxable income above $241,900 (half as much for couple filing separately), single filers with income over $199,250, and heads of household with income over $222,750, with all values indexed for inflation—and maintain the current 15 percent and 0 percent rate schedule at lower incomes. This provision would cost nearly $124 billion through 2021.[8]

The higher rates on capital gains and dividends would increase marginal tax rates on capital income for high-income taxpayers and could reduce private saving. It also might cause corporations to accelerate some dividend payments forward into 2012 to take advantage of the current lower rate.

[7] Lower rates (18 percent and 8 percent, respectively) would apply to assets held for more than five years. The budget proposal would repeal the lower rates on long-held assets.

[8] The $124 billion revenue loss includes a small offsetting revenue gain from eliminating the 8 percent and 18 percent tax rates on capital gains on assets held at least five years.

## Additional Resources

*Tax Policy Briefing Book*: Key Elements of the U.S. Tax System: Capital Gains and Dividends.

### Limit the Value of Itemized Deductions to the 28 Percent Bracket

Taxpayers may reduce their taxable income by subtracting either the appropriate standard deduction or their itemized deductions for medical expenditures, state and local taxes, mortgage interest, charitable contributions, and other allowed expenses. Because deductions reduce taxable income, their effect on tax liability depends on the taxpayer's tax bracket. For example, itemized deductions totaling $10,000 reduce taxes for a person in the 15 percent bracket by $1,500 (15 percent of $10,000) but cut taxes by $3,500 for a person in the 35 percent bracket (35 percent of $10,000). The rationale for some itemized deductions—such as the deduction for extraordinary medical expenses and, arguably, state and local income taxes—is that the deductible expenses reduce the taxpayer's ability to pay and should therefore not count in taxable income. But itemized deductions also subsidize certain behaviors, such as charitable giving and investment in housing, and help states and localities by reducing the net cost to taxpayers of paying higher state and local income, property, and (in some states) sales taxes.

The president proposes limiting the value of itemized deductions to no more than 28 percent starting in 2012, but only for taxpayers with income above specified thresholds. That limit would increase taxes for taxpayers whose tax rate exceeds 28 percent and reduce for them the incentives that the deductions provide. In 2012, those affected would include all taxpayers in the 35 percent tax bracket and some of those in the 33 percent bracket. Starting in 2013, the limitation would apply to taxpayers in the 36 percent and 39.6 percent brackets. The administration estimates that the proposal would increase revenues by about $321 billion through 2021.[9]

This change would interact with Pease (the limitation on itemized deductions). The 28 percent cap on the value of deductions combined with Pease could limit the tax savings from itemizable expenses to as little as 5.6 percent of those expenses—28 percent of the 20 percent minimum deduction allowed under Pease. That value is just one-seventh of the 39.6 percent maximum tax savings that taxpayers in the top tax bracket would get if neither Pease nor the 28 percent limitation were imposed.

By reducing the after-tax cost of allowed expenditures, itemized deductions encourage certain behavior. For example, a taxpayer in the 35 percent bracket effectively pays only 65 cents for each dollar she gives to qualified charities because giving a dollar reduces her tax bill by 35 cents (35 percent of the deductible one-dollar donation). Many studies find that this lower after-tax price of giving increases charitable giving, although the extent of the increase is uncertain. But the incentive varies considerably among taxpayers; taxpayers in the 35 percent bracket pay 65 cents for each dollar they give to charities, taxpayers in the 15 percent bracket pay 85 cents per dollar, and the 65 percent of taxpayers who claim the standard deduction receive no subsidy for charitable giving at all. Other itemized deductions have similar incentive effects. For example, people may buy more or better housing because the deductibility of mortgage interest and property taxes reduces their after-tax costs. Limiting the value of deductions to 28 percent would increase the after-tax cost of charitable giving and other itemizable expenses for high-income taxpayers and would therefore reduce the amount of those activities they would undertake.

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[9] The estimated revenue gain assumes that the 2001–03 tax cuts are extended for couples with income below $250,000 ($200,000 for singles, both 2009 values indexed for inflation) but allowed to expire for higher-income taxpayers.

The 2005 President's Advisory Panel on Federal Tax Reform[10] proposed replacing itemized deductions with a 15 percent credit on most itemizable expenditures. That change would give all taxpayers the same tax savings for a given deductible expenditure, severing the connection between tax rates and the value of deductions. It would recognize the public value attached to particular expenditures but remove those expenditures from the determination of ability to pay. Similar limitations applying to home mortgage interest and charitable contributions were included in the 2010 debt reduction plans of the President's Fiscal Commission and the Bipartisan Policy Center.

The president's proposal would limit the value of deductions for about one-ninth of taxpayers in the top income quintile in 2012, raising their taxes by an average of about $5,000. Just over 80 percent of taxpayers in the top 1 percent would pay more tax, an average increase of more than $11,000. In 2013, after the 2010 tax act expires and top tax rates rise, about one-eighth of taxpayers in the top quintile would pay an average of about $9,000 more tax compared with current law and over 80 percent of those in the top 1 percent would pay an average of more than $20,000 additional tax.

## Distribution Tables

Limit the value of itemized deductions to 28 percent

2012 versus current law by cash income
2012 versus current law by cash income percentiles
2012 versus current policy by cash income
2012 versus current policy by cash income percentiles

2013 versus current law by cash income
2013 versus current law by cash income percentiles
2013 versus current policy by cash income
2013 versus current policy by cash income percentiles

## Additional Resources

*Tax Policy Briefing Book*: Income Tax Issues: What is the difference between tax deductions and tax credits?

President's Advisory Panel on Federal Tax Reform, *Final Report*, November 2005.

"Limit the Tax Benefit of Itemized Deductions to 15 Percent," Congressional Budget Office, *Budget Options: Volume 2*, August 2009, p. 192.

[10] See Report of the President's Advisory Panel on Federal Tax Reform, November 2005.

## Extend the 2001 and 2003 Tax Cuts for Taxpayers at Incomes below Certain Thresholds

The 2001 and 2003 tax acts reduced tax rates on ordinary income, long-term capital gains, and qualified dividends; mitigated marriage penalties; expanded the child tax credit and the child and dependent care tax credit; and phased out the limitation on itemized deductions and the phaseout of personal exemptions. All of those changes were originally scheduled to sunset at the end of 2010, but the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the sunset to the end of 2012. Under current law, the individual income tax will now revert to its pre-2001 levels in 2013.

**Individual Income Tax Parameters in 2013 under Under Current Law and under the Budget "Adjusted Baseline"**

| Income Tax Provisions | | Current Law | 2013 Law Assumed in the Budget "Adjusted Baseline" for Taxpayers with Incomes: | |
|---|---|---|---|---|
| | | | Below Threshold* | Above Threshold* |
| Tax Rates (2013 income ranges for single filers) | $0 - $8,750 | 15% | 10% | 10% |
| | $8,750 - $35,500 | 15% | 15% | 15% |
| | $35,500 - $86,000 | 28% | 25% | 25% |
| | $86,000 - $179,400 | 31% | 28% | 28% |
| | $179, 400 - $199, 350 | 36% | 33% | 33% |
| | $199, 350 - $390, 050 | 36% | N/A | 36% |
| | $390, 050 and over | 39.6% | N/A | 39.6% |
| Standard deduction and 15% tax bracket for joint filers | | 167% of single filers | 200% of single filers | 200% of single filers |
| Child Tax Credit | | $500 | $1,000 | Generally phased out** |
| Child and dependent care credit | Max. creditable amount | $2,400/child, max $4,800 | $3,000/child, max $6,000 | $3,000/ child max $6,000 |
| | Credit rates | 20% - 30% | 20% - 35% | 20% |
| Phaseout of Personal Exemptions | | Over $122,500 range | No phaseout | Over $122, 500 range |
| Limitation on Itemized Deductions | | Up to 80% | No Limitation | Up to 80% |
| Top rate on long-term capital gains | 15% bracket or lower | 10%/8%*** | 0% | 0% |
| | above 15%, below 36% bracket | 20%/18%*** | 15% | 15% |
| | 36% bracket or above | 20%/18%*** | N/A | 20% |
| Top rate on Qualified Dividends | 15% bracket or lower | Regular tax rate | 0% | 0% |
| | above 15%, below 36% bracket | Regular tax rate | 15% | 15% |
| | 36% bracket or above | Regular tax rate | N/A | 20% |

* Threshold for single filers is $200,000 and for joint filers is $250,000 (2009 values, indexed for inflation).
** Very large families with income above the relevant threshold may receive some child credit.
*** Lower rate of 8% or 18% applies to gains on capital assets held at least five years.

The "adjusted baseline" used in the president's budget in place of current law assumes permanent extension beyond 2012 of all the 2001 and 2003 tax cuts for taxpayers with incomes below certain thresholds ($250,000 for joint filers and $200,000 for single filers). The adjusted baseline also assumes that the 2001 and 2003 tax cuts that apply only to taxpayers with incomes above those thresholds expire in 2013 as scheduled. As a result, only the reduction in the tax rate on qualified dividends for higher-income taxpayers shows a revenue loss in the president's budget.

## Index to Inflation the 2011 Parameters of the Individual Alternative Minimum Tax

Under current law, individual taxpayers may be subject to an alternative minimum tax if their tentative AMT liability exceeds their regular income tax liability. Tentative AMT liability is computed using a different rate schedule and different tax base than the regular income tax. The AMT owed is equal to the difference (if any) between tentative AMT liability and liability under the regular income tax.

Since 2001, Congress has repeatedly increased the individual AMT exemption on a temporary basis to prevent too many taxpayers from being subject to the tax. The temporary legislation has also allowed taxpayers to use personal nonrefundable tax credits, including credits for child care and higher education, to reduce tentative AMT liability. Absent these stopgap measures, sometimes called "the AMT patch," the exemption would stay at the nominal levels established in 1993, personal nonrefundable credits would be limited or disallowed by the AMT, and the AMT would affect more than a third of all taxpayers in 2012.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the AMT patch through 2011, setting the AMT exemption levels in 2011 at $48,450 for single and head-of-household filers, $74,450 for married people filing jointly and qualifying widows or widowers, and $37,225 for married people filing separately. The AMT has two tax rates: 26 percent on the first $175,000 of income above the exemption and 28 percent on incomes above that amount. The AMT exemption phases out at a 25 percent rate between $117,650 and $311,450 for singles and heads of household, between $156,850 and $454,650 for married couples filing jointly, and between $78,425 and $227,325 for married couples filing separately. For affected taxpayers, the phaseout creates *effective* AMT tax rates of 32.5 percent—125 percent of 26 percent—and 35 percent—125 percent of 28 percent.

The "adjusted baseline" used in the president's budget in place of current law assumes that the 2011 AMT parameters—exemptions, rate brackets, and phaseout thresholds—are permanently extended and indexed after 2011 for inflation. As a result of this baseline assumption about changes in the AMT, no revenue loss is shown in the president's budget for an AMT patch. Relative to current law, however, the president's proposed AMT patch would reduce revenues by $1.6 trillion between fiscal years 2012 and 2021.

The assumed changes to the AMT would remove a significant source of uncertainty about taxation and prevent inflation from pushing large numbers of taxpayers onto the AMT in future years. Most benefits of the assumed changes would go to taxpayers with relatively high incomes: nearly three-quarters of the tax cut in 2013 would go to households with income over $100,000. Over half of taxpayers with income between $200,000 and $500,000 would see their tax bills drop by an average of almost $3,400, raising their after-tax income by about 1.5 percent.

### Distribution Tables

Extend and index to inflation 2011 parameters of the AMT.

2012 vs. current law by cash income

2012 vs. current law by cash income percentiles

2012 vs. current policy by cash income

2012 vs. current policy by cash income percentiles

2013 vs. current law by cash income
2013 vs. current law by cash income percentiles
2013 vs. current policy by cash income
2013 vs. current policy by cash income percentiles

**Additional Resources**

Tax Topics: Individual Alternative Minimum Tax.

*Tax Policy Briefing Book:* Alternative Minimum Tax.

## Tax Carried Interest as Ordinary Income

The president's budget proposes to tax the income from "carried interest" as ordinary income rather than as capital gains as under current law. Ordinary income is subject to marginal rates up to 35 percent (39.6 percent after 2012) while income from capital gains is taxed at rates up to 15 percent (20 percent after 2012).

Carried interest accrues to certain investment fund managers, including managers of hedge funds and venture capital partnerships. These managers generally receive part of their compensation in the form of an interest in the partnership, which entitles them to a share of partnership profits. If the partnership earns a capital gain, the manager reports his share—the carried interest—as capital gain income. The proposal would treat the manager's share as ordinary income on the grounds that, for the manager, this partnership income represents compensation for services, not a return on investment.

Opponents of the provision argue the manager as a partner is entitled to capital gain treatment under the general rules for taxing partnerships in which the characteristics of a partnership's income (either ordinary income or capital gains) flow through to partners. The difference, however, is that the manager has not purchased his partnership share, but has instead received this interest as a form of compensation for services. No income tax is paid by the manager on the value of the interest when it is received. The carried interest therefore represents a form of deferred compensation rather than a share in the partnership's capital gains income.

The treatment most consistent with similar transactions would tax the estimated value of the partnership interest when received as ordinary income and subsequent profits as capital gains. This approach would treat the manager in the same manner as others who are compensated with shares or other investment interests. However, the value of a carried interest at the time it is received would be difficult in practice to estimate accurately.

Under the president's budget proposal, a partner's share of income from an "investment services partnership interest" (ISPI) would be taxed as ordinary income, regardless of the character of the income at the partnership level. Partners would be required to pay self-employment taxes on income from an ISPI. If a partner sells an ISPI, the gain would be taxed as ordinary income, not as a capital gain. The administration estimates that the provision would raise $14.8 billion through 2021.

Income that a partner earns from capital invested in the partnership would not be recharacterized provided that the partnership reasonably allocates income across invested capital and carried interests.

### Additional Resources

*Tax Policy Briefing Book:* What is carried interest and how should it be taxed?

*Tax Policy Briefing Book:* What are the options for reforming the taxation of carried interest?

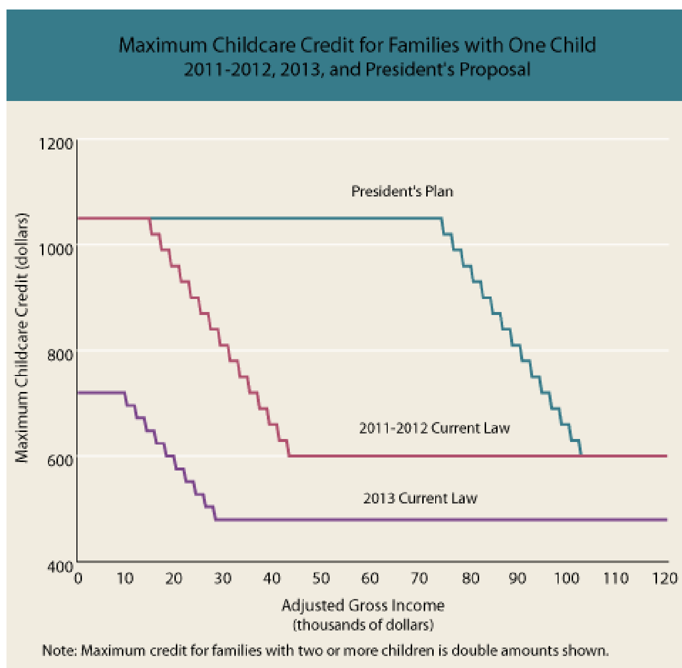
Two and Twenty: Taxing Partnership Profits in Private Equity Funds, Victor Fleischer, *New York University Law Review*, 2008.

Taxing Partnership Profits as Compensation Income, Michael L. Schler, *Tax Notes*, May 28, 2008.

## Expand the Child and Dependent Care Tax Credit

The child and dependent care tax credit (CDCTC) provides a credit of between 20 and 35 percent of up to $3,000 ($6,000 for two or more children) in child care expenses for children under age 13 whose parents work or go to school. Families with income below $15,000 qualify for the 35 percent credit. That rate falls by 1 percentage point for each additional $2,000 of income (or part thereof) until it reaches 20 percent for families with income of $43,000 or more. The credit is nonrefundable—that is, it can only reduce a family's income tax liability to zero; any additional credit is lost.

Absent further extension by Congress, the CDCTC will revert to its pre-EGTRRA maximum credit rate of 30 percent for families with income under $10,000. That rate would fall by 1 percentage point for each additional $2,000 of income until it reaches 20 percent for families with income of $28,000 or more. In addition, the maximum expenditures for which taxpayers can claim the credit will decrease from $3,000 to $2,400 (from $6,000 to $4,800 for two or more children). The maximum credit would thus drop from $1,050 ($2,100 for two or more children) to $720 ($1,440).




President Obama proposes to make permanent both the maximum 35 percent credit rate and the $3,000 maximum for creditable expenses ($6,000 for two or more children). He would also permanently increase to $75,000 the income threshold above which the credit rate starts to phase down beginning in 2012. That rate would decrease by 1 percentage point for each $2,000 of income (or part thereof) over that threshold until it hits a minimum of 20 percent for families with income over $103,000. Relative to 2011 law, for families with income between $43,000 and $75,000, the maximum credit would increase from $600 to $1,050 (from $1,200 to $2,100 for families with two or more children). Families with income between $15,000 and $43,000 or between $75,000 and $103,000 would see smaller increases in the maximum credit they could claim.

The credit offsets part of the cost of caring for young children or other qualifying dependents while parents work or attend school. For workers, the credit effectively increases the net gain from work, which could boost their willingness to seek employment. That effect would only apply to the secondary worker in married couples since both parents in a couple must work or be in school in order to qualify for the credit. Because the credit is not refundable, however, it provides little or no benefit to low-income families—those most likely to react to a credit change. These families receive little or no benefit, regardless of the credit rate.

More than half of benefits from extending the phase-out would accrue to families in the middle income quintile. Because it is nonrefundable, the larger credit would do almost nothing for families in the bottom fifth of the income distribution, and only about 17 percent of the benefits would accrue to families in the second quintile.[11] Expanding the credit would cost an estimated $9.6 billion over 10 years.

### Distribution Tables

Raise the Child and Dependent Care Tax Credit Phaseout Threshold to $75,000
2013 versus current policy by cash income
2013 versus current policy by cash income percentiles

### Additional Resources

*Tax Policy Briefing Book:* Taxation and the Family: How does the tax system subsidize child care expenses?

Quick Facts: Child and Dependent Care Tax Credit (CDCTC).

[11] The changes noted in the text are measured relative to credit amounts in 2011 without expiration of EGTRRA (see table).

### Extend the Earned Income Tax Credit for Larger Families

The economic stimulus act ("American Recovery and Reinvestment Act of 2009") increased the earned income tax credit rate for working families with three or more children from 40 percent to 45 percent in 2009 and 2010. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 subsequently extended that increase for two years and consequently increased the maximum credit for families with three or more children from $5,112 to $5,751 in 2011. The act also increased the phaseout income levels for all married couples filing a joint tax return (regardless of the number of children) to $5,080 above the thresholds for single filers in 2011. The president proposes to make both changes permanent and to index for inflation the $5,080 higher phaseout threshold for married couples filing jointly.

The higher credit rate for larger families could induce them to work more, although research suggests any impact would be small. Lengthening the phaseout range would change which families face higher marginal tax rates because of the phaseout, but have only small effects on overall work effort. The main effect of the proposal would be to increase after-tax incomes of affected families. The provision would cost an estimated $12.3 billion over the next decade.

### Additional Resources

*Tax Policy Briefing Book:* Taxation and the Family: What is the Earned Income Tax Credit?

Stimulus Act Report Card: Increase in Earned Income Tax Credit

### Extend the American Opportunity Tax Credit

The economic stimulus act ("American Recovery and Reinvestment Act of 2009") established and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the "American Opportunity" tax credit (AOTC) as a replacement for the Hope credit through 2012. The president proposes to make the AOTC permanent and index for inflation both the maximum expenditures eligible for the credit and the income thresholds above which the credit phases out, beginning after 2012.

The AOTC is a partially refundable tax credit equal to 100 percent of the first $2,000 plus 25 percent of the next $2,000 spent on tuition, fees, and course materials during each of the first four years of postsecondary education for students attending school at least half time. The maximum credit is $2,500 a year. In contrast, the Hope credit was available for only the first two years of postsecondary education and was not refundable. As was the case for the Hope credit, taxpayers may not claim the AOTC for any expenses paid using funds from other tax-preferred vehicles such as 529 plans and Coverdell Savings Accounts. Each student in a household may claim the AOTC, the lifetime learning credit, or the deduction for tuition expenses in a given year—but not more than one of them. All students in the same home need not choose the same tax benefit. If the budget proposal does not pass, the Hope credit would return in 2012, after the expiration of the AOTC.

Forty percent of the AOTC is refundable, which makes it available to households with little or no tax liability. The maximum refundable credit is $1,000 (indexed for inflation), 40 percent of the $2,500 maximum total credit.

The credit phases out evenly for married couples filing joint tax returns with income between $160,000 and $180,000 and for others with income between $80,000 and $90,000. Couples with income above $180,000 and others with income above $90,000 may not claim the credit. The president proposes to index the phaseout thresholds for inflation starting after 2012.

The larger, refundable credit would continue to extend educational assistance to low-income students, making it easier for them to afford college and thus encouraging attendance. Indexing both the credit and the phaseout ranges would maintain the real value of the credit over time. However, because the cost of higher education has risen much faster than the overall inflation rate, the credit would still likely cover a smaller share of education costs in future years. The credit's phaseout boosts marginal tax rates for affected taxpayers and could discourage work effort for some students or parents. Because most students qualify for the credit, colleges might react by raising tuition, thereby shifting some of the benefits from students receiving the credit to colleges and, the case of public institutions, to state taxpayers. Extending the credit would cost an estimated $93.6 billion over the next ten years.

### Additional Resources

Stimulus Act Report Card: "American Opportunity" Tax Credit.

Tax Topics: Education Tax Incentives.

**Require Automatic Enrollment in IRAs and Enhanced Small Employer Startup Credit**

The president proposes to establish automatic enrollment in IRAs for employees without access to an employer-sponsored saving plan. Currently, workers who wish to contribute to an IRA must first establish the account, actively make a decision to contribute each year, transfer funds into the IRA, and decide how to invest their contributions. The president proposes to make this process automatic. Under the proposal, most employers who do not currently offer retirement plans—except those with less than 10 employees or firms in business less than two years—would have to enroll employees in a direct-deposit IRA account unless the worker opts out. The default contribution rate would equal 3 percent of compensation, and contributions would automatically go into standard, low-cost investments. Furthermore, the default option would be a Roth IRA, funds for which come from after-tax income and are untaxed upon withdrawal, as opposed to a deductible IRA, which is funded from pretax income and from which withdrawals are subject to income tax.

Research has shown that changing the default from an opt-in provision to an opt-out provision markedly increases worker participation in 401(k)–type plans, especially for demographic groups with traditionally low saving rates. The administration suggests that this trend will hold for automatic enrollment in IRAs, increasing saving rates for workers without workplace retirement plans and helping to reverse the nation's prolonged trend of low saving rates.

In conjunction with automatic enrollment, the administration proposes a modest credit of up to $250 per year per business, for not more than two years, to help small businesses cover the costs of automatic enrollment. In addition, the proposal would double the existing tax credit for small businesses starting new employee retirement plans from $500 to $1,000, available for a maximum of three years.

Requiring automatic enrollment in IRAs and doubling the retirement plan startup credit for small businesses would cost $14.4 billion through 2021. However, making Roth IRAs the default option reduces the short-term cost of automatic enrollment since the tax benefit of Roth IRAs—and the consequent revenue loss—does not come until workers withdraw funds in retirement. That outcome shifts much of the cost of this proposal beyond the 2012–21 budget window, causing the 10-year revenue loss to substantially understate the provision's lifetime cost.

**Additional Resources**

Tax Policy Briefing Book: Savings and Retirement: How might saving be encouraged for low- and middle-income households? http://www.taxpolicycenter.org/briefing-book/key-elements/savings-retirement/encourage.cfm.

Tax Topics: Pensions and Retirement Savings, http://www.taxpolicycenter.org/taxtopics/Retirement-Saving.cfm.

Benjamin H. Harris and Rachel M. Johnson, "Automatic Enrollment in IRAs: Costs and Benefits," *Tax Notes*, August 31, 2009, http://www.taxpolicycenter.org/UploadedPDF/1001312_auto_enroll.pdf.

## Make the 2009 Estate Tax Permanent

In 2001, Congress voted to phase out the estate tax gradually and repeal it entirely in 2010. The 2010 tax act reinstated the tax with an effective $5 million exemption and a 35 percent tax rate. The act also for the first time allowed portability of the exemption between spouses: any of the $5 million exemption not used when one spouse dies may be added to the exemption available for the second spouse (if he or she has not remarried). However, unless Congress acts, the estate provisions in effect prior to 2001 would be reinstated starting in 2013, Under these provisions, estates valued at $1 million or more would again be subject to tax at progressive rates as high as 60 percent, and portability would disappear.

The Obama budget proposes permanently setting the estate tax at its 2009 level beginning in 2013: estates worth more than $3.5 million would pay 45 percent of taxable value over that threshold. It would also make portability permanent, allowing couples to share a combined exemption of $7 million. Relative to current law, the proposal would cost $271 billion in forgone revenues through 2021.

The Tax Policy Center estimates that about 3,600 estates will owe estate tax in 2011, representing less than 0.2 percent of deaths in that year. If the pre-2001 estate tax applied, more than 40,000 estates would have owed tax, about 2 percent of decedents. Had Congress made the 2009 estate tax permanent as the president proposed in his 2011 budget, about 5,500 estates would have paid the tax. All three of those versions of the tax would affect only the estates of very wealthy people.

The exemption and the tax rate have different effects on larger and smaller estates. A larger exemption prevents more estates from paying any tax but has relatively little effect on the amount of tax paid by the largest estates. In contrast, a lower tax rate reduces the tax owed for all taxable estates but saves the most money for the largest estates. Compare, for example, raising the exemption from $1 million to $3.5 million with cutting the tax rate from 55 percent to 45 percent. The exemption increase would reduce the number of taxable estates by more than 80 percent from about 44,000 to roughly 5,500 in 2011 and would save larger estates $1.38 million in tax (at a 55 percent rate). The rate cut would have a much larger effect for large estates: an estate with a taxable value of $5 million (after the exemption and any deductions) would save $500,000 while an estate worth $500 million would save $50 million in tax.

### Distribution Tables

Make 2009 estate tax permanent and broaden estate tax base[12]

- 2013 versus current law by cash income
- 2013 versus current law by cash income percentiles
- 2013 versus current policy by cash income
- 2013 versus current policy by cash income percentiles

### Additional Resources

Tax Topics: Estate and Gift Taxes.

*Tax Policy Briefing Book*: Key Elements of the U.S. Tax System: Wealth Transfer Taxes.

[12] See "Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms" for base-broadening proposals in TPC's 2012 budget analyses.

### Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms

In addition to making them permanent at their 2009 levels, the president proposes a number of changes to estate, gift, and generation-skipping transfer taxes, in part to simplify the tax and in part to reduce opportunities to avoid or minimize tax liability.

- **Make permanent the portability of unused exemptions between spouses**

The 2010 tax act included an estate tax provision that allows a surviving spouse to use any excess estate tax exemption not used by the deceased spouse, but only through 2012. The president proposes to make this provision permanent. Although many couples could have done effectively the same thing under prior law through estate planning, doing so required advance planning and could not necessarily cover increases in the surviving spouse's wealth over the individual exemption. Allowing portability of a couple's exemptions between spouses allows couples to take advantage of their combined exemption without having to retitle assets and include special provisions in their wills. The provision would reduce revenues by about $3.7 billion over 10 years.

- **Require consistency in value for transfer and income tax purposes**

Assets transferred by gift or bequest must be valued in specified ways in determining estate and gift taxes. The resulting value generally becomes the recipient's basis for the asset. The administration proposal would require recipients to use as their basis no higher value than that used by the donor and require that either the donor or the estate executor provide recipients with appropriate values. As a result, recipients of gifts or bequests could not reduce taxes they would subsequently owe on asset sales by claiming a higher basis and hence a lower capital gain. The administration estimates that the provision would raise about $2.1 billion over 10 years.

- **Modify rules on valuation discounts**

Transfers of property by gift or bequest are generally subject to gift or estate tax. Provisions in the Internal Revenue Code attempt to prevent various methods of reducing the value of such transfers—and hence the applicable tax—but some restrictions have become less effective. The president proposes to limit valuation discounts on family-controlled entities. The provision would increase revenues by about $18 billion over 10 years.

- **Require a minimum term for grantor-retained annuity trusts**

If an interest in a trust is transferred to a family member, tax law requires that any interest retained by the grantor have zero value in determining any transfer tax except if the retained interest is "qualified." One case of qualified interest is a grantor-retained annuity trust (GRAT) in which the grantor receives the annuity for a specified period (based on how long the grantor expects to live) and the residual trust passes to beneficiaries. In such a case, the present value of the annuity is subtracted from the value of the trust in determining transfer taxes. (If the grantor dies during the term of the annuity, some portion of the trust's assets is included in the decedent's estate.) GRATs can minimize transfer taxes, particularly if the trust's assets appreciate in value. Minimizing the term of the GRAT reduces the likelihood that the grantor will die during its term.

The president proposes to require that GRATs have a minimum term of 10 years, that any remainder interest have a value greater than zero, and that the annuity cannot be reduced during

the GRAT's term. Those restrictions would minimize the value of the GRAT by increasing the risk that the grantor dies during its term and thus loses potential tax savings. The provision would raise revenues by about $3 billion over 10 years.

- **Limit duration of generation-skipping transfer tax exemption**

The president proposes to limit the tax exemption for generation-skipping transfers (GSTs) by limiting the term over which such exemption applies. The provision aims to prevent perpetual trusts through which assets can pass tax-free through multiple generations. The provision would have a negligible effect on revenues.

### Distribution Tables

Make 2009 estate tax permanent and broaden estate tax base[13]

2013 versus current law by cash income
2013 versus current law by cash income percentiles
2013 versus current policy by cash income
2013 versus current policy by cash income percentiles

### Additional Resources

Tax Topics: Estate and Gift Taxes

*Tax Policy Briefing Book*: Key Elements of the U.S. Tax System: Wealth Transfer Taxes

[13] See "Make 2009 estate tax permanent" for proposal to change basic estate tax parameters in TPC's 2012 budget analyses.

## Make the Research and Experimentation Tax Credit Permanent

Since its enactment as a temporary provision in 1981, the research and experimentation (R&E) tax credit has been extended, with modifications, 14 times. It is currently scheduled to expire on December 31, 2011. The president would make the R&E tax credit permanent and increase the rate of a simplified alternative credit option from 14 percent to 17 percent. Making the credit permanent would reduce federal receipts by $106.2 billion between fiscal years 2012 and 2021.

The R&E credit is an incremental credit. Businesses may claim a nonrefundable credit equal to 20 percent of qualified expenditures in excess of a base amount. The base is generally determined by multiplying a company's average annual gross receipts in the previous four years by its ratio of research expenses to gross receipts during the 1984 to 1988 period. (Companies that did not exist during the base period must use a fixed ratio of 3 percent.) The base cannot be less than 50 percent of qualified research expenses for the taxable year. Firms may elect to use an alternative simplified method that sets the credit at 14 percent of the increase of current-year qualified research expenses over 50 percent of the average of the same expenses for the previous three years. If the business does not have qualified expenses in any one of the three preceding years, then the alternative credit is determined by taking 6 percent of the current year's qualified expenses. The president would increase the rate of the alternative credit from 14 to 17 percent.

The rationale for the credit is that investment in research and development often generates social returns (general knowledge or other social benefits) that exceed the private returns to investment. Without government intervention, firms would invest less in research than is socially desirable, making the economy less productive. Supporters argue that the credit provides an important stimulus to research spending. A 2008 Congressional Research Service report (cited below) found, however, that the credit delivered only a modest stimulus to domestic business research and development between 1997 and 2005. Making the credit permanent might increase its effectiveness because firms may currently forgo lengthy research projects for fear that Congress might allow the credit to lapse although, given past history, that fear could be overstated. Making the credit permanent would give a more realistic picture of its future budgetary costs; given the repeated extension of the credit, the sunset provision leads to an understatement of cost over the 10-year budget window. Critics of the credit acknowledge that some research generates social benefits not captured by the firms that perform it, but point out that not all qualifying research and development generates such excess benefits. The credit may also induce some firms to choose projects that qualify for the credit over those that generate higher returns.

### Additional Resources

Congressional Research Service, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress* (CRS Report RL31181, updated October 6, 2008), http://www.ncseonline.org/NLE/CRSreports/08Aug/RL31181.pdf.

Government Accountability Office, *The Research Tax Credit's Design and Administration Can Be Improved* (GAO-10-136) November 6, 2009, http://www.gao.gov/new.items/d10136.pdf.

### Increase Credits for Energy-Efficient Investments

Current law contains numerous incentives to promote investments in conservation, renewable energy and energy-saving technologies by individuals and households. Many of these incentives are temporary. The president would extend a number of provisions scheduled to expire at the end of 2011 through calendar year 2012.

The president is also proposing two expansions of existing tax incentives. One proposal would raise the budgetary ceiling on tax credits for investments in qualified advanced energy projects by an additional $5 billion over a two-year period after the date of enactment of the proposal. In general, these projects include those that expand facilities to generate renewable energy, facilitate use of hybrid vehicles, reduce energy use, capture and sequester carbon dioxide emissions, or in other ways reduce greenhouse gas emissions. The current cap on the subsidy is $2.3 billion. Because the projects are eligible for a credit equal to 30 percent of amounts invested, the additional $5 billion in credits would support over $15 billion in additional qualifying investments. The Obama administration notes that many technically acceptable projects have not been funded because of the current limitation and that lifting the ceiling would allow quick deployment of new investments. The higher ceiling on tax credits would reduce revenues by $3.7 billion over 10 years.

The president is also proposing to replace the existing tax deduction for energy-efficient commercial building property expenditures with a tax credit that would offset 100 percent of creditable expenditures for property placed in service in calendar year 2012. The amount of creditable expenditures for any property would be limited based on the square footage of the property and the extent to which the investment reduces annual energy and power costs. The provision would cost just over $1 billion through 2021.

By reducing consumption of fossil fuels, the projects the Obama administration would subsidize may reduce greenhouse gas emissions that contribute to global warming, reduce U.S. dependence on insecure world oil markets, and accelerate the development of new technologies that might ultimately be viable without government subsidies. A more direct and efficient way to achieve these goals is to raise the price of greenhouse gas emissions, either by imposing an excise tax on CO2 emissions or establishing emissions limits with tradable permits (“cap and trade”). But if such a direct approach is not politically feasible, subsidies to conservation and renewable energy technologies could generate net economic benefits if the investments they subsidize would be economically viable at prices that reflect the full social costs of consuming fossil fuels. The disadvantage of using subsidies is that government is not necessarily good at picking the winners among competing technologies. In addition, because many of the current tax incentives are scheduled to expire with a short time period, they may not be effective in stimulating projects with a long time horizon.

### Additional Resources

Eric Toder, “Energy Taxation: Principles and Interests,” *Energy – A Special Supplement to Tax Notes, State Tax Notes, and Tax Notes International*, November 27, 2006.

*Tax Policy Briefing Book:* “Taxes and the Environment.”

## Provide New Tax Incentives for Regional Growth

### Extend and modify the New Markets Tax Credit

The New Markets Tax Credit (NMTC) was designed to stimulate the flow of capital into low-income and economically distressed areas by giving investors a tax incentive to invest in qualified Community Development Entities (CDEs). The CDEs, in turn, provide capital directly to low-income areas by investing in projects or organizations located or operating in qualified census tracts. Investors receive a tax credit equal to 5 percent of the investment amount in each of the first three years following their initial investment, and a credit equal to 6 percent of the investment amount in each of the following four years. In total, investors receive a credit equal to 39 percent of the initial investment amount. Investors are required to maintain their investment in the CDE for the entire seven-year period. If the investment isn't maintained, investor can no longer claim the credit, and income tax liabilities on the project will increase to recapture the credits previously received plus interest resulting from the underpayment of tax liability.

CDEs are certified by a branch of the Treasury, the Community Development Financial Institutions Fund (CDFI Fund), and participate in a competitive process for the right to receive tax-preferred financing. A qualified CDE is a corporation, partnership, or other entity that is engaged in the development of a low-income area, defined as a census tract with a poverty rate in excess of 20 percent, or with a median family income below the greater of the median income for metropolitan areas or statewide median income (only the latter criterion is used for non-metro areas). Qualifying CDEs must invest at least 85 percent of their tax-preferred financing in the development of a low-income community. CDEs may be community development banks, venture funds, or for-profit subsidiaries of community development corporations, among others. Through 2008, the CDFI Fund had authorized $19.5 billion in NMTC financing.

The American Recovery and Reinvestment Act (ARRA) increased the annual limit on allowable tax-preferred investment from $3.5 billion to $5 billion in 2008 and 2009 and allowed investors to claim the tax credits against the AMT in 2009.[14] Under current law, the NMTC will expire on December 31, 2011.

The president proposes extending the NMTC for an additional year through 2012. The extension would allow for the higher allocation amounts implemented under ARRA—$5 billion per year—and would allow the NMTC to be creditable against the AMT. The administration estimates that the provision would cost $1.9 billion through 2021.

### Additional Resources

Government Accountability Office, New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified, http://www.gao.gov/new.items/d10334.pdf.

[14] The $1.5 billion in additional allowable investment in 2008 was directed toward rejected applicants or those recipients who did not receive their full requested allocation.

### Reform and Extend Build America Bonds

Build America Bonds (BABs) were a new borrowing tool for state and local governments that were enacted as part of the American Recovery and Reinvestment Act of 2009. These bonds are conventional taxable bonds issued by state and local governments. Treasury makes direct payments to state and local government issuers (called "refundable tax credits") to subsidize a portion of their borrowing costs in an amount equal to 35 percent of the coupon interest on the bonds. Issuance of BABS is limited to original financing for public capital projects for which issuers could have used tax-exempt "government bonds." The direct payments to states are thought to be more efficient than the indirect subsidy through tax-exempt interest for lenders because the entire benefit of the subsidy goes to the borrower. In contrast, the federal revenue cost of the tax exemption is often greater than the borrowing cost savings realized by state and local governments because the bonds must pay enough interest to be attractive to investors below the highest tax bracket. Because the 35 percent payment is higher than the percentage reduction in the cost of borrowing from tax-exemption, BABs also provide a larger subsidy to states and localities than tax exemption. ARRA authorized the issuance of BABs through 2009 and 2010; the program ceased at the end of 2010.

The program appeared to be successful in expanding the market for state and local debt. From April 2009 through December 2010, more than $181 billion in BABs were issued in over 2,275 transactions in all 50 states and the District of Columbia. During this period, BABs accounted for more than 25 percent of the total dollar supply of state and local debt. The program taps into a broader market of investors than tax-exempt securities, including investors not subject to U.S. income tax (pension funds and foreign investors). BABs also relieved supply pressures in the tax-exempt bond market and helped reduce interest rates in that market.

BABs were more limited in their issuance uses than tax-exempt bonds. Tax-exempt bonds and BABs could both be used for original financing of public capital projects. However, tax-exempt debt (but not BABs) could also be used for refunding existing debt for interest cost savings; meeting short-term working capital needs; providing capital financing for code 501(c)(3) nonprofit entities; and providing qualified private activity bond financing for specified private projects and programs (including, for example, low-income housing projects, mass commuting facilities etc.), which are subject to an annual state bond volume cap.

The president proposes to reintroduce BABs and make them a permanent addition to state and local government borrowing options at a 28 percent federal subsidy level. (The 28 percent subsidy would make the budgetary cost per dollar of BABs approximately equal to the cost per dollar of tax-exempt bonds.) The proposal would also expand the eligible uses for BABs to include all state and local tax-exempt functions *except* private activity financing. The marketing and issuing costs of offering BABs has fallen as investors became more aware of the product. Given the lower cost per dollar subsidy offered through direct credit to states, reintroducing BABs on a revenue-neutral basis makes sense.

The expected cost of this program from 2012 to 2021 is $28 million.

### Additional Resources

U.S. Treasury Build America Bond web page.

## Low-Income Housing Tax Credit Provisions

The Low-Income Housing Tax Credit (LIHTC) is an indirect federal subsidy used to finance the development of affordable rental housing for low-income households. Each year the IRS allocates housing tax credits to designated state agencies (typically housing finance agencies) which in turn award these credits to developers of qualified projects. States are limited to an allocation of $1.75 per resident. (Only the first-year credit counts toward the limit.) Provided the property maintains compliance with the program requirements, investors receive a dollar-for-dollar credit against their federal tax liability annually for 10 years. The annual credit is based on the amount invested in the building. The president proposes two changes to the credit.

- **Encourage mixed-income occupancy by allowing LIHTC-supported projects to elect an average-income criterion**

Under current law, for a building to qualify for the LIHTC, a minimum portion of the units in the building must be rent-restricted and occupied by low-income tenants. The taxpayer makes an irrevocable election between two criteria:

- at least 20 percent of the units must be rent-restricted and occupied by tenants with income at or below 50 percent of the area median income (AMI) or
- at least 40 percent of the units must be rent-restricted and occupied by tenants with incomes at or below 60 percent of AMI.

In all cases, income standards are adjusted for family size and the size of the credit reflects the fraction of the building's eligible basis that is attributable to the low-income units. In practice, this leads to buildings that serve a narrow income band of tenants—usually those just below the top of the eligible income range.

The president proposes adding a third criterion that would require that at least 40 percent of the units need to be occupied by tenants with incomes that *average* no more than 60 percent of AMI. No rent-restricted unit could be occupied by a tenant with income above 80 percent of AMI, and any unit with an income unit below 20 percent would be treated as a 20-percent limit. This should encourage a broader income distribution of tenants.

- **Provide a 30-percent "boost" to properties that receive tax-exempt bond financing**

The LIHTC is computed based on a building's adjusted basis. In some situations, there is an increase over the amount that would otherwise be eligible basis. For example, state housing finance agencies can designate a building as needing an enhanced credit in order to be financially feasible as part of a qualified low-income housing project, then the eligible basis of the building can be up to 130 percent of what it would be in the absence of any such boost. This basis boost is not available if any portion of the eligible basis of the building is financed by tax-exempt bonds subject to the private-activity volume cap.

This has led to some problems in financing preservation of existing affordable housing units. Many units are currently being lost due to an inability to fund necessary capital improvements and maintenance. The proposal would allow state housing financing agencies to designate certain

projects to receive, for purposes of computing LIHTC, a 30 percent boost in eligible basis. To receive this treatment, a project would have to satisfy the following requirements:

- the project involves the preservation, recapitalization, and rehabilitation of existing housing;
- the housing demonstrates a serious backlog of capital needs or deferred maintenance;
- at least half of the aggregate basis of the building and of the land on which the building is located is financed by tax-exempt bonds that are subject to the volume cap; and
- the project involves housing that was previously financed with federal funds and because of that funding the housing was subject to a long-term use agreement limiting occupancy to low-income households.

The additional volume of designations that a state housing finance agency can issue would be limited by an amount based on the state's volume cap. These proposals are estimated to cost $872 million over the 2012–21 period, with the first proposal (income eligibility averaging) estimated to cost $110 million and the second (basis boost for preservation) $762 million.

**Designate Growth Zones**

The Internal Revenue Code contains various targeted incentives to encourage the development of particular geographic regions, including empowerment zones and the Gulf Opportunity (GO) Zone. There are currently 40 empowerment zones—30 in urban areas and 10 in rural areas—that have been designated through a competitive application process in 1994, 1998, and 2002. State and local governments nominated distressed geographic areas, which were selected on the strength of their strategic plans for economic and social revitalization. The Secretary of Housing and Urban Development designated the urban areas while the Secretary of Agriculture designated the rural areas. In addition, the District of Columbia Enterprise Zone (DC Zone) was established in 1998, and the GO Zone was established in 2005 in the aftermath of Hurricane Katrina. Empowerment zone designations remain in effect through December 31, 2011.

Businesses that operate in these zones are eligible for various incentives including tax credits for qualifying wages, additional expensing for qualified zone property, tax-exempt financing for some facilities, deferral of capital gains on sales and reinvestment in zone assets, and exclusion of 60 percent (rather than 50 percent) of the gain on the sale of qualified small business stock held more than five years. Eligibility for these credits requires that employees primarily live and provide services within the zone and that most of the business's gross income comes from the active conduct of business within the zone. Residents of empowerment zones age 18–39 qualify as a targeted group for the work opportunity tax credit (WOTC). The DC and GO Zones provide additional targeted incentives.

Because the current empowerment zones are scheduled to expire at the end of 2011 and because some of them have been in effect for 16 years, the Obama administration wants to reassess where resources should be targeted to provide the most benefit going forward. The budget proposes a national competition for growth zone status from which the administration would designate 20 growth zones (14 in urban areas and 6 in rural areas). The designation and tax incentives would be in effect for five years from 2012 through 2016. The Secretary of Commerce would select the zones in consultation with the secretaries of Housing and Urban Development and Agriculture. These designations will be based on the strength of the applicant's "competitiveness plan" and its need to attract investment and jobs.

Two tax incentives would apply to growth zones. Businesses that employ zone residents could claim employment credits that would be similar to the enterprise zone credit. The credit would equal 20 percent of the first $15,000 of wages for zone residents hired to work within the zone and 10 percent for those working outside of the zone. Second, qualified property placed in service within the zone would be eligible for additional first-year depreciation of 100 percent of the adjusted basis of the property. To evaluate the effectiveness of the growth zone program, the Secretary of the Treasury would collect data from taxpayers on the use of such tax incentives in each zone, and the Secretary of Commerce may require the nominating local government to provide other data on the economic conditions in the zones before and after designation. The growth zone program is expected to cost $3.7 billion from 2012 through 2016 but then raise revenues in subsequent years due to the loss of depreciation on assets previously expensed, reducing the net cost to $2.5 billion over the 2012–21 period.

If the federal government is going to provide incentives to develop specific geographic areas, it should periodically reevaluate designated areas using up-to-date information. However, there is little evidence that the earlier creation of Empowerment Zones has led to economic

revitalization. Data limitations, including the inability to accurately measure where funds were utilized, make evaluation difficult. A GAO report found that while improvements in poverty, unemployment, and economic growth had occurred in these zones, econometric analysis could not tie these changes to the additional incentives available through the program. Indeed, the requirements for better data collection and tracking is due to limitations of earlier studies and an increased emphasis on the need to evaluate these programs.

**Additional Resources**

GAO Briefing for Congress, March 12, 2010, "Information on Empowerment Zone, Enterprise Community, and Renewal Community Programs."

**Restructure Assistance to New York City: Provide Tax Incentives for Transportation Infrastructure**

The Job Creation and Worker Assistance Act of 2002 provided tax incentives for the area in New York City damaged or affected by the terrorist attacks on September 11, 2001. The Act created the "New York Liberty Zone" in lower Manhattan and provided tax incentives, including an expansion of the work opportunity tax credit for Liberty Zone employees, a special depreciation allowance for qualified property, a five-year recovery period for depreciation of qualified leasehold improvement property, $8 billion of tax-exempt private activity bond financing for certain property, $9 billion of additional tax-exempt, advanced refunding bonds, increased expensing, and an extension of the replacement period to avoid taxation of gains on involuntary conversions that were due to the terrorist attacks.

Some of the tax benefits that were provided to New York following the attacks of September 11, 2001, likely will not be usable in the form in which they were originally provided. The president's budget proposes converting some of the tax benefits into credits for improvements to transportation infrastructure. The proposal would provide tax credits to New York State and New York City for expenditures relating to the construction or improvement of transportation in or connecting to the Liberty Zone. The tax credit would be allowed in each year of the 2012–21 period, subject to an annual limit of $200 million, with the designation and authorization of projects split evenly between the city and the state, with unused credits allowed to be carried over into the following year including years after 2021. Because of that unlimited carryover, the administration estimates the 10-year cost of the program at $2 billion.

### Eliminate Taxation of Capital Gains on Qualified Small Business Stock

The Omnibus Budget Reconciliation Act of 1993 allowed noncorporate taxpayers to exclude a portion of the capital gain on qualified small business stock from tax if the stock is held for at least five years. In general, 50 percent of the gain is excluded (60 percent for businesses in empowerment zones); the remaining gain is taxed at a maximum rate of 28 percent. The 2009 stimulus bill (the American Recovery and Reinvestment Act) raised the exclusion to 75 percent for stock acquired between February 17, 2009, and January 1, 2011. The Small Business Job Act again raised the exclusion, to 100 percent, for stock acquired after September 27, 2010, and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the 100 percent exclusion to stock acquired before January 1, 2012.

The maximum gain eligible for the exclusion is limited to the greater of $10 million ($5 million for married taxpayers filing separately) less any gain reported on prior tax returns, or 10 times the taxpayer's cost basis (purchase price plus fees).

For stock acquired before September 27, 2010, a portion of the excluded gain is an AMT preference item (that is, it is added to the AMT measure of income and thus subject to the alternative tax). The AMT preference is currently 28 percent of the excluded gain on stock acquired since 2001 and before September 27, 2010, and 42 percent on stock acquired before 2001.

To qualify as a small business, the corporation may not have gross assets of $50 million or more at issuance and may not be an S corporation. The business must also meet certain active trade or business requirements. As a result, small businesses in the service sector, hospitality, farming, finance, insurance, and mineral extraction generally do not qualify for special treatment.

Under current law, the exclusion will revert to 50 percent after 2012 (60 percent for businesses in empowerment zones), and the maximum effective capital gains tax rate on qualifying small business stock will double to 14 percent (11.2 percent in empowerment zones).

The president's budget proposes to permanently exempt capital gains on qualifying small business stock acquired after December 31, 2012—thus reducing the effective tax rate to zero—and to eliminate the AMT preference. The proposal would encourage more investment in some small businesses that qualify, but could also divert capital from more productive investments in firms that do not qualify for the benefit. By eliminating the second layer of tax, it would also encourage more qualifying firms to incorporate as C-corporations. Because of holding requirements, the proposal would cost nothing through 2016 but would then reduce revenues by $5.4 billion through 2021. The costs would rise in future years as more investments would qualify for the exemption from tax.

### Additional Resources

*Tax Policy Briefing Book:* Capital Gains and Dividends: How are capital gains taxed?

The Complexity of Capital Gain Taxation, *TaxVox*, February 24, 2009.

### Eliminate Fossil Fuel Tax Preferences

The federal income tax includes a number of tax preferences that encourage investment in exploration, development, and extraction of fuels from domestic oil and gas wells and coal mines. The costs of these tax preferences through 2016 are displayed in the Analytical Perspectives section of the federal budget. The two largest tax preferences are as follows:

- *Excess of percentage over cost depletion, fuels*. Under normal income tax rules, producers of oil, gas, and coal would be able to recover the costs of their investments in wells and mines every year in proportion to the share of the resource extracted (cost depletion). But current law instead allows independent producers to deduct a percentage of gross income from production (percentage depletion), subject to certain limits. The excess of percentage of cost depletion will cost $5.8 billion between 2012 and 2016.
- *Expensing of exploration and development costs*. Under normal income tax rules, exploration and development costs for oil and gas wells and coal mines would be capitalized and recovered as resources are extracted from the property. But current law allows independent producers to deduct immediately intangible drilling costs (IDCs) for investments in domestic oil and gas wells. (Integrated producers may deduct 70 percent of IDCs and amortize the remaining 30 percent over five years.) Businesses may also deduct exploration and development costs of surface stripping and the construction of shafts and tunnels for other fuel minerals. Expensing of exploration and development costs will cost $2.3 billion between 2012 and 2016.

Other tax expenditures for fossil fuels listed in the budget (and their 2012–16 costs) include a two-year amortization of geological and geophysical expenditures ($0.3 billion), capital gains treatment of royalties on coal ($0.3 billion), and an exception from the passive loss limitation for working interests in oil and gas properties ($0.2 billion). The tax code also provides subsidies for certain expenditures for more costly forms of oil extraction, including a credit for enhanced oil recovery expenditures, a deduction for tertiary injections, and a credit for oil and gas produced from marginal wells. (Some of these incentives have no projected cost because they apply only when oil prices are below a threshold level, which prices now exceed.)

In addition to these targeted tax expenditures, current law provides a much broader subsidy for domestic U.S. production activities: a special 9 percent deduction from taxable income. This deduction reduces the effective top tax rate on corporate income from domestic production from 35 percent to 31.9 percent and will cost $82.0 billion for all qualified domestic production between 2012 and 2016. Production from domestic oil and gas wells and domestic coal mines benefits from this deduction, but no more than any other qualified domestic production.

The Obama administration proposes to eliminate special tax benefits for domestic fossil fuel production. The proposals and their revenue gains between 2011 and 2021 include these seven:

- Repeal percentage depletion for oil and natural gas wells and hard mineral fossil fuels ($12.6 billion)
- Repeal expensing of intangible drilling costs for oil and gas and expensing of exploration and development costs for coal ($12.9 billion)
- Increase amortization period for geological and geophysical amortization period for independent producers to seven years ($1.4 billion)

- Repeal capital gains treatment for coal royalties ($0.4 billion)
- Repeal the exemption to the passive loss limitation for working interests in oil and natural gas properties ($0.2 billion)
- Repeal the deduction for tertiary injectants ($0.1 billion)
- Repeal the enhanced oil recovery credit and the credit for oil and gas produced from marginal wells (no revenue effect, based on projections of world oil prices)

The president also proposes to repeal the domestic manufacturing deduction for oil, gas, and coal production. This proposal would partially remove a large tax subsidy for domestic manufacturing but would place energy industries at a *disadvantage* relative to other domestic manufacturing (but not relative to service industries, which do not receive the benefit). Repealing the domestic manufacturing deduction for oil and gas would raise $18.3 billion over 10 years; repealing the deduction for coal and other hard mineral fossil fuels would raise another $0.4 billion.

In general, a neutral tax system promotes an efficient allocation of investment by encouraging choices by business and households that maximize the economic productivity of assets instead of their tax benefits. Tax subsidies for selected assets and industries distort markets and cause too much output of favored goods and too much investment in favored assets or technologies. Eliminating tax subsidies for fossil fuel production would improve economic efficiency by encouraging capital to flow to assets with higher pretax returns. Eliminating these preferences would also raise prices and reduce world output of fossil fuels, thereby reducing carbon emissions and contributing to climate policy goals. But because these resources are traded on world markets, the principal effect of reducing subsidies for U.S. domestic production would be to increase U.S. imports (of oil) and reduce exports (of coal). In other words, eliminating the subsidies will mainly affect the location of production, not world prices and global energy use.

The effects on economic efficiency of eliminating the domestic production deduction for oil, gas, and coal production are less clear than the effects of eliminating targeted tax subsidies for fossil fuels. The current law deduction gives a tax advantage to domestic manufacturing relative to services. Removing the domestic production deduction for oil and gas eliminates the tax preference for that sector, but it introduces a new bias favoring other manufacturing over fossil fuel production. The domestic production deduction also favors domestic over foreign activities of U.S. companies, but that may partly offset other provisions in the tax law—such as the deferral of tax on income accrued within foreign affiliates—that favor investment in low-tax foreign countries over domestic investment.

### Impose a Financial Crisis Responsibility Fee

In response to widespread disruption and uncertainty in financial markets, President Bush signed the Emergency Economic Stabilization Act into law on October 3, 2008. The centerpiece of that legislation was the Troubled Asset Relief Program (TARP), which authorized the U.S. Treasury to purchase and hold up to $700 billion in assets in order to stabilize the financial system. Section 134 of that Act requires that any shortfall from the TARP program be recouped from the financial industry. As of November 2010, the Congressional Budget Office estimates the net cost of the TARP program at $25 billion.

The president proposes to assess a 0.075 percent fee on certain liabilities of all large financial firms operating in the United States. The fee would apply to all banks, thrifts, bank or thrift holding companies, securities broker-dealers, or any firm owning such an entity on or after January 14, 2010, with consolidated assets of more than $50 billion. Domestic firms would be assessed based on their total worldwide assets; foreign firms would be assessed based on the consolidated assets of their U.S. subsidiaries. The base of the fee would exclude high-quality (Tier 1) capital, along with certain liabilities required for regulatory purposes, such as FDIC-insured deposits and insurance policy reserves, and certain loans to small businesses. The fee would be deductible against the corporate income tax. This proposal would take effect January 1, 2013.

In many respects, the proposed fee acts as a “too-big-too-fail tax,” similar in spirit to deposit insurance. Whereas banks pay the FDIC a fee to guarantee depositors’ accounts against bank failure, the financial crisis responsibility fee can be seen as a form of insurance payment for the government’s anticipated (although not promised) support during times of widespread financial distress. While the fee may discourage excessive risk-taking at the margin, its overall impact on financial sector risk is likely to be modest and insufficient to prevent future credit bubbles, such as the subprime mortgage loans at the heart of the recent crisis.

The Obama administration estimates that the proposal would raise $30 billion over the next 10 years. Banks could pass at least part of the fee along to customers in the form of higher fees and/or interest rates; that would be more likely to occur for services dominated by large institutions (such as investment banking services).

### Additional Resources

TARP Transaction Reports, FinancialStability.gov.

White House, “Financial Crisis Responsibility Fee Fact Sheet,” January 14, 2010.

**Reform International Taxation Rules**

The president proposes to reform international tax laws to limit the benefits of income shifting to low-tax foreign jurisdictions. The proposals in the budget are similar to those proposed in the previous two budgets. They aim to limit international tax avoidance and reduce incentives for U.S. corporations to invest overseas instead of in the United States. In combination, the proposals would raise $129 billion between 2012 and 2021.

Currently, the United States taxes both the domestic and foreign earnings of U.S. corporations. When a firm pays U.S. taxes on its foreign profits depends on how its parent company organizes its foreign operations. If an operation is organized as a subsidiary (that is, it is separately incorporated in the foreign country), then its profits are *generally* not taxed until they are paid to the U.S. parent. The exemption of foreign profits until they are repatriated to the parent company is called deferral. If an operation is organized as a branch (that is, it is not separately incorporated in the foreign country), then its profits are taxed when they are earned.

Not all classes of foreign-source income earned by foreign subsidiaries enjoy deferral. Under "Subpart F" of the current tax law, certain "passive" income such as income earned from investments in foreign assets, foreign base company sales and services income, and income from the insurance of U.S. risk is taxed upon accrual. These exceptions to the general rule of deferral intend to protect the U.S. base by limiting firms' ability to shift income not arising from active business activities to low-tax foreign jurisdictions. In addition, the parent company pays U.S. tax immediately on dividends, interest, or royalties paid by one subsidiary to another. That last rule does not apply, however, to payments within a corporation—for example, from a local branch to the home office.

To prevent income earned abroad from being taxed twice, the United States allows firms to claim tax credits for income taxes paid to foreign governments. Firms can use these tax credits to offset U.S. tax liability on foreign-source income. A limitation on the credit for foreign taxes prevents U.S. firms from using these credits to reduce U.S. tax liabilities on income earned at home. The limit is the amount of tax that would be due if the foreign income were earned in the United States.

To understand how the credit works, consider a U.S. company that earns $100 in a subsidiary located in a country with a tax rate of 25 percent, so the subsidiary pays $25 tax to the host country. If the subsidiary immediately remits the $100 of earnings to the parent company, the parent company owes $35 of U.S. tax on the $100 (since the U.S. corporate tax rate is 35 percent). However, the company may claim a $25 credit for the tax paid to the foreign country, leaving a net U.S. tax of only $10 (the $35 tax minus the $25 credit).

If the foreign tax rate were 45 percent, and as before the profits are sent home to the parent, the firm would owe $45 in foreign tax, $10 more than the $35 U.S. tax liability. A firm in this situation is said to have "excess credits" of $10 (the $45 foreign tax minus the $35 U.S. tax) because its foreign tax payment exceeds the U.S. credit it may claim in the current year. In some situations, the foreign tax credit system allows firms to use excess credits from one source of foreign income to offset U.S. tax payments on income from another source in a procedure called "cross-crediting."

To understand how cross-crediting works, consider a company with both of the subsidiaries described above. Cross-crediting allows the parent corporation to use the $10 of excess credits of

the second subsidiary (in the high-tax country) to offset the $10 net U.S. tax liability on the first subsidiary (in the low-tax country). In this case, simultaneously repatriating income from subsidiaries in both high- and low-tax countries results in no net U.S. tax liability on the $200 of foreign-source income.

Differences in taxation between the United States and other countries give multinational companies an incentive to alter their transfer prices—that is, the prices they charge for goods purchased from and sold to their affiliates—from what a nonaffiliated customer would be charged. For example, by underpricing sales to their affiliates in low-tax countries and overpricing purchases from them, companies can shift reported profits to their affiliates in those countries, thus reducing tax on the entire corporate group. To deal with this practice, most governments require firms to use an "arm's length" standard for tax reporting purposes, setting transfer prices equal to the prices that would prevail if the transaction were between independent entities. Yet ample room remains for firms to manipulate transfer prices because arm's-length prices are often difficult to establish for many intermediate goods and services, especially for intangibles, such as patents, that are unique to the firm.

There are other ways for firms to shift income from high- to low-tax countries. For example, by borrowing money in high-tax countries to finance their overall operations, they can claim larger interest deductions in those countries and so report more profits in low-tax countries. Research using Treasury tax files suggests that two of the most important vehicles for income shifting are placing debt in high-tax locations and transferring very valuable intangible assets to low-tax subsidiaries without adequate compensation in the form of royalties. Treasury economist Harry Grubert reports that location of intangible income and the allocation of debt among high- and low-tax countries seem to account for all of the observed differences in profitability among high- and low-statutory tax countries.

The president proposes a package of revenue-raising reforms of the international tax system that would affect both the deferral and foreign tax credit features of current law as well as income shifting. The bulk of the revenue raised from these provisions would come from changes related to the deduction of interest expenses against deferred foreign income, the calculation of the foreign tax credit, and the treatment of returns associated with the transfer of intangibles abroad to affiliated foreign companies. All the provisions would take effect in 2012.

**Changes related to the deduction of interest expenses against deferred foreign income.** Under current law, companies with overseas operations may immediately deduct expenses supporting foreign investment while deferring payment of taxes on profits from those investments until they repatriate the profits. Under the president's proposal, companies could not claim deductions on their U.S. tax returns for interest expenses that are properly allocable to foreign-source income until they pay U.S. taxes on their foreign earnings. The provision would effectively limit the benefit of deferral by raising the cost of delaying U.S. tax payments on foreign profits. The rules governing the provision are complicated and have uneven effects across different industries and companies. Multinational companies that are heavily leveraged would suffer most from the provision.

**Changes related to foreign tax credits.** The president proposes to limit cross-crediting by requiring firms to consider the foreign tax they pay on all of their foreign earnings and profits in determining their foreign tax credits. Under current law, the foreign tax credit is based on earnings and profits on which U.S. tax has been paid. Companies receive foreign tax credits for

foreign taxes paid on deferred income when they repatriate that income. This enables them to coordinate repatriations from low- and high-taxed income sources to maximize their foreign tax credits. The provision would limit firms' ability to blend their repatriations to minimize or avoid U.S. taxes on foreign source income. By so doing, this proposal would reduce cross-crediting and further limit the benefits firms receive from deferral.

The budget also includes a provision aimed at reducing credits for foreign taxes that may be associated with specific economic benefits that a foreign country provides to a taxpayer. Current law contains regulatory provisions that limit the amount of creditable foreign tax for these "dual capacity" taxpayers. The proposal replaces these regulations with an explicit allocation rule to determine how much credit can be claimed.

**Changes related to income shifting.** The president proposes two measures to prevent the inappropriate shifting of income outside the United States through the transfer of intangible property.

One proposal would scrutinize the income arising from transfers of intangible property. If a U.S. company transfers an intangible asset (such as a patent) to a related foreign company in a country with a low effective tax rate and circumstances indicate that there is excessive income shifting into the low-tax country, then under the proposal, the return that is deemed to be "excessive" would be taxed currently and not allowed deferral. This proposal reflects a belief that the current transfer pricing regulations are not working adequately for intangible property transfers, providing a backstop method of limiting the benefits from income shifting. A second proposal would strengthen the transfer pricing regulations by clarifying the definition of intangible property in an effort to reduce controversy that has arisen in IRS examinations. In addition, the proposal would clarify that when valuing intangible property, the IRS may take into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction taken. This seems to be a movement away from the "arm's length" standard for transfer pricing. Finally, this second provision would allow the IRS commissioner to value multiple intangible properties on an aggregate basis if doing so would achieve a more reliable result.

Two other measures to limit income shifting would limit earnings stripping by expatriated entities and disallow the deduction for non-taxed reinsurance premiums paid by affiliates. The former proposal would limit the ability to reduce tax on income from U.S. operations through the deductions of interest from debt to related foreign parties. The latter proposal would prevent insurance companies from avoiding the subpart F rules limiting deferral of income of a foreign affiliate through reinsurance transactions with a related foreign party not subject to U.S. income tax.

Taken as a group, the international tax reform proposals would limit the benefits of deferral, limit the ability of companies to shift reported income to low-tax foreign affiliates, and limit their ability to avoid the effects of foreign tax credit limitations. Limiting income shifting protects the corporate tax base by helping ensure that income earned in the United States is not erroneously classified as foreign-source income. In addition, by limiting the tax benefits of investing overseas instead of in the United States, the proposals intend to prevent U.S. multinational companies from shifting employment from home production to overseas operations. But some research finds that foreign investment may increase domestic employment in U.S. multinationals if the investments facilitate more exports to foreign affiliates. And employment in the United States is

influenced more by overall fiscal and monetary policies that determine the quantity of American-made goods, services, and assets that American and foreign consumers and investors are willing to purchase than by policies that move jobs from one activity to another.

Policies to limit tax benefits that favor investments by U.S. companies in low-tax countries could boost economic efficiency by providing better incentives for companies to invest where the pretax returns are greatest. But these increased taxes on foreign-source income apply only to U.S.-based multinational companies and not to foreign-based companies that, in most countries are exempt from tax on their active foreign-source income. As a result, opponents of these provisions argue that they would place U.S.-based companies at a competitive disadvantage to multinationals based in other countries and would encourage new corporations to establish their tax residence outside the United States.

### Additional Resources

*Tax Policy Briefing Book*: International Taxation: How does the current system of international taxation work?

Eric Toder, "Will Paring Deferral Create Jobs?" *TaxVox*, May 5, 2009.

Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Location," *National Tax Journal*, Volume LVI, No.2, Part 2.

Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment (JCS-4-09)," September 2009.

### Reform Treatment of Insurance Companies and Products

The budget contains three proposals that would change the tax treatment of insurance companies and their products. In combination, the proposals would raise about $14 billion through 2021.

**Expand pro rata interest expense disallowance for corporate-owned life insurance.** An insurance company will accrue interest on life insurance policies, which generally increases the policies' cash surrender value. This interest is not taxable under current law. If a company could borrow to purchase such a policy and deduct the interest, it would be matching currently deductible interest against tax-free income. Accordingly, interest on borrowing to purchase or carry life insurance is generally not deductible. Further, since it would often be difficult to trace borrowing used to fund the purchase of insurance, a pro rata portion of the corporation's interest expense is disallowed to the extent it has "unborrowed" cash value under life insurance policies (Section 264(f)). However, this rule does not apply if the policy covers the life of an individual who is an employee, officer, or director of the corporation. This proposal would repeal that exception for policies issued after December 31, 2011, increasing revenues by $1.2 billion over 10 years. The exception for policies covering the life of a 20 percent owner of the business would remain

**Modify dividends received deduction for life insurance company accounts.** In general, corporations may deduct between 70 percent and 100 percent of dividends received from other corporations in order to avoid taxing that income twice at the corporate level. Under current law, an allocation rule for life insurance companies disallows the deduction with respect to the portion of the dividend that is allocated to policyholders and not the company. This proposal aims to limit the share of the dividend to which the deduction applies to no more than the company's economic interest in the dividend, all while making the allocation system less complex and more consistent with the treatment of other corporations. This proposal would be effective for taxable years beginning after December 31, 2011, and would raise about $5.1 billion through 2021.

**Modify rules that apply to sales of life insurance contracts.** Investors sometimes purchase existing life insurance contracts, thus providing the sellers of those contracts with immediate payment in return for the buyers getting insurance payments when insured individuals die. Death benefits received by a decedent's family are not taxed, even if the insurance amount exceeds the premiums paid. In general, however, an investor with no financial interest in the insured must pay tax on the amount of insurance collected less the amount paid for the policy and premiums paid by the investor. But various exceptions may give investors an incentive to structure the purchase of insurance contracts to avoid subsequent tax liability. This proposal would modify transfer rules to make those exceptions inapplicable for investors, thus ensuring that investors pay tax on their gains and increase revenues by $7.7 billion over 10 years. It would also impose reporting rules on the transfer of policies with a death benefit of $500,000 or more. The new rules would apply to transfers of policies and payments of death benefits for taxable years beginning after December 31, 2011.

## Revise Tax Treatment of Inventories

### Repeal LIFO

Many businesses hold inventories of goods, both inputs and products for sale. Because the purchase of inventory represents an exchange of cash for an equal value of assets, firms cannot deduct inventory when purchased. Instead, firms deduct the cost of inventory against the sale of goods in computing net profit. Because otherwise-identical goods moving out of inventory can have different costs, depending on when they were acquired, firms rely on specific conventions to account for the costs of goods sold.

Most companies use the first-in-first-out (FIFO) method, which assumes that the goods first purchased are the ones first sold. The cost of the goods on hand at the end of the year—the firm's inventory—reflects the most recent purchases. Alternatively, companies can elect to use the last-in-first-out (LIFO) method if they also use LIFO for financial statement purposes. This method assumes that the goods last purchased are the ones first sold. This means that goods first purchased make up the firm's inventory at the close of the year. If prices are rising, LIFO allocates higher costs to goods sold than FIFO, which reduces current taxable income and assigns a lower value to the year-end inventory.

The president's budget proposes repeal of the election to use LIFO for income tax purposes. Taxpayers that currently use the LIFO method would be required to write up—that is, revalue—their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. To prevent a large spike in tax liability, this one-time increase in gross income from the write-up of existing inventory would be taken into account ratably over the 10 years beginning after December 31, 2011. The change would increase revenues by about $53 billion over the next 10 years.

Under LIFO, as long as sales during a year do not exceed purchases, all sales are matched against purchases in the same year, and the opening inventory is never considered to have been sold. Therefore, a company that has used LIFO for many years will have a stock of inventory on its tax returns with a much lower value than its current acquisition price. Repealing LIFO and making companies pay tax on the accrued difference between the LIFO and FIFO valuations of their inventory would impose a substantial one-time tax (paid over 10 years under the proposal) and a smaller permanent annual tax as long as prices are increasing. Affected companies have benefitted from lower taxes in previous years, however, so the one-time tax could be viewed as repayment of those tax savings.

Proponents of repeal argue that LIFO has no value as a management tool and serves only to cut tax liability for a relatively small number of firms. Proponents of repeal also point out that LIFO is currently prohibited under the International Financial Reporting Standards. Opponents of repeal argue that LIFO makes the effective tax rate on inventory comparable to that on machinery and buildings and that repeal would overtax inventory. Further, they argue that in the presence of inflation, FIFO taxes firms on profits that represent changes in the price level instead of real economic profits and that LIFO may represent a better approximation of real economic income.

### Repeal LCM

Companies that do not use LIFO may write down the value of their inventories by applying the lower-of-cost-or-market (LCM) method rather than the cost method, or write down the value of "subnormal" goods (ones that cannot be sold at the normal price or cannot be used as intended).

The president's budget proposes to prohibit the use of the LCM or subnormal methods for taxable years beginning after December 31, 2012. The one-time increase in income due to revaluing existing inventories that were valued using these methods would be taken into account ratably over four years and increase federal revenue by about $8 billion through 2021.

The LCM and subnormal goods methods allow taxpayers to reduce taxable income for anticipated losses on inventories before the losses occur when the inventory is sold. However, there is no corresponding requirement that anticipated gains on inventories be included in taxable income before the gains occur. This asymmetric treatment accelerates inventory losses and defers inventory gains, misstating the timing of income and reducing tax revenues.

### Additional Resources

Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, Is It Time to Liquidate LIFO? *Tax Notes*, October 16, 2006.

Alan D. Viard, Why LIFO Repeal Is Not the Way to Go, *Tax Notes*, November 6, 2006.

### Reinstate Superfund Taxes

The Superfund trust fund is used to clean up contaminated sites. Parties found liable for contaminating the sites generally bear the cost of Superfund cleanups. The Superfund trust fund covers the costs when liable parties no longer exist or either cannot or will not undertake a cleanup.

The Superfund program has in past received funding from two sources: general funds from the Treasury and balances in the Superfund trust fund. In earlier years, revenues for the trust fund came from three dedicated excise taxes and an environmental corporate income tax. Those taxes expired in December 1995, however, and the amount of unobligated money in the fund gradually declined to zero by the end of fiscal year 2003. The Superfund trust fund has been funded almost entirely through general revenues ever since.

Before they expired, the Superfund taxes included an excise tax of 9.7 cents per barrel on crude oil or refined oil products; excise taxes of $0.22 to $4.87 per ton on certain hazardous chemicals; an excise tax on imported substances that use one or more of the hazardous chemicals subject to excise tax in their production or manufacture; and an environmental income tax of 0.12 percent on the amount of a corporation's modified alternative minimum taxable income that exceeds $2 million. The president would reinstate these taxes beginning January 1, 2012, and expiring after December 31, 2021. During that period, the levies would raise an estimated $20.8 billion.

Proponents of reinstating the Superfund excise taxes argue that imposing these taxes is consistent with a "polluters pay" principle: industries and companies that used hazardous substances and purchasers of products that generate hazardous wastes should bear the cleanup costs. Proponents also argue that the Superfund taxes may discourage the use of toxins and, ultimately, hazardous waste. But the pollution in question is legacy contamination, so the incidence is unlikely to reach culpable parties. In addition, the taxes may distort economic behavior without giving businesses an incentive to handle hazardous wastes more carefully or avoid producing them. Taxes placed directly on current waste ("waste end" taxes) would be more efficient. The corporate income tax component of the Superfund taxes would contribute additional revenues for cleanup activities, but it is extremely complex, requiring firms to compute a corporate AMT liability even if they do not owe any tax. And, in contrast to the excise taxes, the amount of corporate environmental income tax has no connection to the source of current or prior pollution.

### Additional Resources

Congressional Research Service Report on Superfund Taxes (CRS Report RL31410).

### Extend Certain Expiring Provisions through 2012

The revenue code includes dozens of "temporary" tax incentives, many of which have been extended one year at a time for a decade or more. The most significant in terms of revenue provides temporary relief from the alternative minimum tax (a provision discussed elsewhere in this review). Most others are highly targeted subsidies that benefit business. The most significant of these in terms of revenue is the research and experimentation credit (also known as the research and development credit and discussed elsewhere in this review). Others encourage a broad range of investment from alternative energy to low-income housing.

The "adjusted baseline" used in the president's budget in place of current law assumes permanent extension of AMT relief. The 2011 AMT parameters—exemptions, rate brackets, and phaseout thresholds—are made permanent and indexed for inflation after 2011 at a 10-year cost of $1,550 billion. The president's budget also includes a separate proposal to enhance the research credit and make it permanent, at a cost of $106 billion over 10 years.

In addition to these proposals to make some expiring provisions permanent, the president's budget would extend a number of other expired or expiring provisions through 2012, with a 10-year cost of more than $21 billion. These provisions include incentives for alcohol fuels, the optional deduction for state and local general sales taxes, the Subpart F "active financing" and "look-through" exceptions, the modified recovery period for qualified leasehold improvements and qualified restaurant property, and expensing for various forms of investment.

Observers disagree over whether annually extending these tax benefits is good policy or whether it would be better to treat them as permanent provisions of the tax code. Proponents argue that temporary tax cuts allow for regular congressional review, while critics say that in practice no real review occurs. Meanwhile, although many beneficiaries act as if the provisions are permanent, congressional delay in reenacting them in a timely manner can lead to uncertainty and weaken some of the intended incentives. In addition, if these provisions are never allowed to lapse, as past history would suggest, the practice of proposing short-term extensions with an expectation they will be renewed again substantially understates their true long-run budgetary cost.

### Additional Resources

Tax Policy Briefing Book: Taxes and the Budget: What are extenders?

Tax Extenders and Fiscal Responsibility, *TaxVox*, May 29, 2008.

Estimated Budget Effects of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (JCX-54-10), Joint Committee on Taxation, December 2010.

List of Expiring Federal Tax Provisions 2010-2020 (JCX-2-11), Joint Committee on Taxation, January 21, 2011.

## Expand the Federal Unemployment Tax Act Base and Make the Unemployment Insurance Surtax Permanent

Unemployment insurance (UI) is financed by a combination of state and federal taxes on employers based on the wages of each employee. Due to the length of the current downturn and the relatively low levels of state reserves at the beginning of the recession, states have accrued a large level of debt to the federal UI trust fund. The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the federal/state unemployment benefits system. This 6.2 percent rate includes a temporary surtax of 0.2 percent (begun in 1976 and extended since then). Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent.

While states could set their taxable wage bases below the federal taxable wage base, employers in these states would not receive the entire credit. Currently, no state has a taxable wage base below the federal level; instead, 47 states set their taxable wage base at a higher level, with Washington the highest at $37,300 for 2011. (The current federal base was set in the 1980s, and the states with the highest state taxable wage bases automatically adjust their wage bases for inflation.) Federal requirements are also not satisfied when states have exhausted their funds and need to borrow from the federal government to pay benefits. States are required to pay back the borrowed amount including interest. Thus, net federal tax rates on employers increase in indebted states (since they are not eligible for the full credit) to repay the loans. Affected states also must increase state payroll tax rates or the covered wage base to rebuild their funds.

Currently, 30 states have exhausted their UI trust funds in the face of high unemployment and are borrowing from the federal government. Outstanding loans, which totaled $41 billion at the end of 2010, are projected to climb to a record $65 billion in 2013. Employers in indebted states will face immediate tax increases to repay these debts, which could discourage job creation at a time when growth is needed. In addition, states may address their short-term debt burden by limiting eligibility or benefits paid to unemployed workers.

The president's budget proposes two changes. The first would make the existing 0.2 percent surtax permanent. The second would provide short-term relief to employers by suspending interest payments on state UI debt and suspending the FUTA credit reduction for employers in borrowing states in 2011 and 2012. The proposal would also raise the annual FUTA wage base to $15,000 per worker in 2014, index the wage base to subsequent wage growth, and reduce the net federal UI tax from 0.8 percent (after the proposed permanent extension of the FUTA surtax) to 0.38 percent. States with wage bases below $15,000 would have to conform to the new FUTA base. States would retain the ability to set their own tax rates, as under current law.

Given the current depletion of funds and the lack of job growth in the recovery, these proposals make sense. Postponing an increase in unemployment taxes can encourage new hiring, while increasing the base will help states accumulate larger balances before the next recession. In addition, indexing the wage base for the tax will prevent future erosion of unemployment funds by inflation. Making the 0.2 percent surtax permanent would raise $15 billion between 2012 and 2021, while the combination of providing short-term tax relief to employers and expanding the federal base would raise $46 billion over the same period.

**Additional Resources**

U.S. Department of Labor, "UI Data Summary FY 2011 Budget Mid-session Review."

Center for Budget and Policy Priorities, "Rebuilding the Unemployment Insurance System."

### Expand Surface Transportation Funding

The president proposes to expand funding for surface transportation—highways, mass transit, and passenger rail—but does not endorse a specific financing mechanism. Instead, the budget includes a placeholder for $435 billion in new transportation revenues over the 2012–21 period. Those payments would reduce corporate profits, individual incomes, or other parts of the federal tax base. The increase in transportation revenues would thus be partly offset by a $107 billion decline in receipts from other taxes. Taking that into account, the president's proposal amounts to a net revenue increase of $328 billion.

The new transportation revenue would be deposited in a Transportation Trust Fund, an expanded version of the Highway Trust Fund. About 90 percent of trust fund receipts currently come from excise taxes on gasoline (18.4 cents per gallons) and diesel (22.4 cents per gallon). Additional receipts come from various taxes on heavy trucks: a yearly ownership tax, an excise tax on their tires, and a sales tax. The president's proposal would more than double revenues allocated to surface transportation over the next decade. If this were done by increasing motor fuel taxes—an approach that the budget neither endorses nor opposes—it would amount to an increase in the gasoline tax of roughly 25 cents per gallon, on average, over the next decade and an increase in the diesel tax of roughly 30 cents per gallon.

The president's proposal is motivated by two factors. First, highway and mass transit spending has exceeded trust fund receipts in recent years; as a result, the Highway Trust Fund has received transfers from general revenues. Second, the president wants to expand surface transportation spending. To maintain or expand transportation funding—without relying on general revenues—would require additional revenues.

In principle, those revenues could come from several sources. One option would be to increase existing taxes on motor fuels. However, many of the external costs of driving—congestion and road wear-and-tear—depend on the number of miles traveled, the time of day, and the weight of vehicles rather than the amount of motor fuel used. For that reason, some analysts recommend that any new transportation funding be based on a combination of mileage and vehicle weight rather than fuel usage. With new technologies, such mileage- and weight-based fees could vary by time of day and location and thus be a tool for raising revenue, charging for road damage, and combating congestion. The president's budget, however, does not suggest such an alternative financing mechanism.

### Additional Resources

Congressional Budget Office, *Spending and Funding for Highways*, January 2011.

**Other Revenue Proposals**

**Provide $250 refundable tax credit for certain retirees not eligible for Social Security benefits.** The president proposes to make $250 payments to Social Security beneficiaries, disabled veterans, and retired railroad workers. Some retired federal, state, and local retirees would not qualify for these benefits, so the president proposes to provide them with a refundable tax credit instead. This provision—which nicely illustrates how some tax cuts are substitutes for spending programs—would cost $0.2 billion in 2011 and 2012.

**Repeal gain limitation for dividends received in reorganization exchanges.** This provision would increase revenue by $0.8 billion over the next decade.

**Deny deduction for punitive damages.** This provision would increase revenue by $0.3 billion over the next decade.

**Introduce a fee on production of hardrock minerals to restore abandoned mines.** Coal producers currently pay a fee to finance the reclamation of abandoned coal mines. The president proposes a similar fee on production of hardrock minerals such as gold and copper to finance the reclamation of those mines. The proposed fee would be based on the volume of material displaced beginning in 2012. It would raise $1.8 billion over the next decade.

**Increase Oil Spill Liability Trust Fund financing rate by one cent.** The Oil Spill Liability Trust Fund is financed by an excise tax on certain crude oil and petroleum products. That tax is currently 8 cents per barrel, rising to 9 cents in 2017. The president proposes to increase the tax to 9 cents per barrel in 2012 and to 10 cents in 2017; the proposal would increase receipts by $0.5 billion over the next decade.

**Reform inland waterways funding.** The Inland Waterways Trust Fund finances locks, dams, and related infrastructure for use by inland barges. The fund is currently financed by a 20-cents-per-gallon excise tax on diesel used in inland waterways commerce. The president proposes to "work with Congress" to identify a way to raise an additional $0.9 billion for this trust fund over the 2011–21 period.

**Increase fees for Migratory Bird Hunting and Conservation Stamps.** Proceeds from the sale of "Duck Stamps" are used to acquire habitats—breeding areas, wintering areas, etc.—for migratory birds. The president proposes to increase the price of these stamps from $15 per stamp a year (the price since 1991) to $25 per stamp a year beginning in 2012. This proposal would increase revenues by $0.1 billion over the next decade.

**Promote trade.** The president proposes to enact pending trade agreements with Panama, Colombia, and South Korea, reform U.S. preference programs, and establish favorable trading zones in Afghanistan and the border regions of Pakistan. In total, these proposals would reduce revenues from custom duties and other sources by $7.4 billion over the next decade.

**Repeal and modify information reporting on payments to corporations and payments for property.** Taxpayers must typically file a Form 1099 whenever they make payments totaling $600 or more to a recipient for services or determinable gains in the course of a trade or business. The 2010 health care legislation expanded information reporting requirements to

include payments to corporations and payments for property beginning in 2012. This requirement is widely viewed as imposing a substantial burden on small businesses. As a result, the president proposes to replace it with a requirement limited to payments for services but excluding payments for property. This proposal would reduce revenue by $9.2 billion over the next decade.

**Increase certainty surrounding worker classifications.** Businesses must distinguish between workers who are employees and those who are independent contractors. The president proposes to allow the Internal Revenue Service to provide greater guidance about appropriate worker classification and to require prospective reclassification of those who are misclassified. This proposal would increase revenue by $8.7 billion over the next decade.

**Increase program integrity efforts.** The president proposes to provide additional resources to the Internal Revenue Service for enforcement and compliance activities. Prior budgets have generally not recorded savings from such efforts, nor have they assumed a decrease in receipts when enforcement budgets have failed to keep up with increased workloads and labor costs. However, the current budget projects $55.7 billion in revenue increases from increased IRS enforcement over the next decade. Other, smaller program integrity efforts are credited with raising an additional $0.6 billion.

### Indexing the Budget Tax Proposals

Much of the federal income tax is indexed for inflation to prevent nominal income growth from pushing taxpayers into higher tax brackets and the consequent higher effective tax rates, a phenomenon known as "bracket creep." Most but not all of the tax proposals in the 2012 budget include indexing provisions and as a result, they will maintain their value over time in real terms.

Some proposals would maintain their real values because they interact with tax parameters that are indexed. However, two individual income tax proposals would lack indexing—the increased refundability of the child tax credit and the expansion of the child and dependent care tax credit. The earnings level at which refundability of the child credit would start to phase in for low-income families would be fixed permanently at $3,000. Over time, that value would decline in real terms, effectively extending the refundability of the credit to lower income households and increasing the value of the credit for many families. The reverse would hold for the childcare credit: the threshold at which the credit rate would begin to phase down from 35 percent to 20 percent would remain fixed at $75,000 and the maximum amount of spending eligible for the credit would stay at $3,000 ($6,000 for more than one child). As a result, the value of the credit would decline in real terms over time.