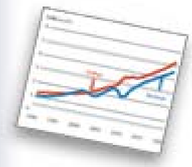
Tax Proposals in the 2011 Budget

Tax Policy Center
Urban Institute and Brookings Institution

The Tax Policy Center offers the table below as a guide to the tax provisions of President Obama's 2011 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 at http://www.taxpolicycenter.org/taxtopics/2011_budget_tables.cfm

Tax Policy Center
2011 BUDGET
Tax Proposals
2010-2020 Revenue Changes in Billions



Temporary Recovery Measures			
Making Work Pay Credit	-61	Temporary increased expensing for small businesses	*
Cash assistance to states in lieu of housing tax credits	-0.2	Temporary bonus depreciation for certain property	-2
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Individual Tax Provisions			
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Eliminate Advanced Earned Income Tax Credit	1	Limit value of itemized deductions to 28%	291
Business Tax Provisions			
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Make research & experimentation credit permanent	-86	Reform U.S. international tax system	117
Reform treatment of financial institutions	93	Combat Under-Reporting in Offshore Jurisdictions	5
Codify economic substance doctrine	4	Reinstate Superfund Taxes	19
Increase certainty regarding worker classification	7	Repeal LIFO	59
Eliminate fossil fuel tax preferences	39	Reform treatment of life insurance companies	14
		Business provisions not evaluated[3]	45
Individual and Business			
Continue remaining expiring provisions through CY 2011	-56	Reduce the tax gap and make reforms	14
Extend and modify new markets tax credit	-3	Modify estate and gift tax rules	24
Total, all tax provisions	**1,065**		
Tax revenue adjustments to administration baseline4			
Index 2009 parameters of the AMT to inflation	-672	Continue the 2001 and 2003 tax cuts	-2,739
Make 2009 estate tax permanent	-264	Expand earned income and child tax credits	-98**

* Less than $50 million.

** The administration includes expanded refundability of the child credit and part of the expansion of the earned income credit in its baseline. The $98 billion revenue cost of those provisions over the 2010-2020 period is included under "Tax revenue adjustments to baseline." Of that cost, $15 billion results from providing more EITC to married couples and $83 billion comes from expanding the child credit.

1. Provide $250 refundable credit for some government retirees ($0.3 billion); extend COBRA health insurance premium assistance ($9 billion); and provide tax credits for investment in some advanced energy projects ($4 billion).
2. Couples with income over $250,000 and single people with income over $200,000.
3. Modify cellulosic biofuel producer credit ($25 billion); make unemployment insurance surtax permanent ($14 billion); other tax increases ($12 billion); and other tax cuts (-$5 billion).
4. The Administration baseline continues the 2001 and 2003 tax cuts (with the estate tax fixed at 2009 law), indexes the 2009 AMT parameters for inflation, and expands the earned income and child tax credits.

Descriptions of tax provisions and revenue estimates come from Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, February 2010.

Revenue effects shown in the table cover 11 years—2010-2020—even though the budget would begin in 2011, when most of the tax changes would take effect. Some proposed tax changes would affect revenue in 2010 because of behavioral changes.

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 2001-2003 tax cuts, makes the estate tax permanent with 2009 parameters, indexes the exemption for the alternative minimum tax (AMT) from its 2009 level, increases the earned income credit for married couples, and expands refundability of the child credit for low-income working families.

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 2001-2003 tax cuts expire in 2011 as scheduled (including changes in the estate tax) and that the AMT exemption reverts to its permanent value after 2010. Our current policy baseline assumes permanent continuation of the 2001-2003 tax cuts for all taxpayers, the estate tax at its 2009 level ($3.5 million effective exemption and a 45 percent tax rate), and an indexed patch to the AMT that maintains its exemptions at the real levels in effect in 2009.

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.

Tax Proposals in the 2011 Budget*

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Introduction

The Tax Policy Center has examined the key tax proposals in President Obama's 2011 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 2001-2003 tax cuts are permanent (including the estate tax at its 2009 level), the exemption in the alternative minimum tax (AMT) is permanently indexed for inflation from its 2009 level, and that temporary expansions of refundability of the child tax credit and of the earned income credit are permanent. Those provisions would reduce revenues by $3.8 trillion over the 2010-2020 period. 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 2001-2003 tax cuts expire as scheduled in 2011 and that the AMT exemption maintains its permanent level.[1] Against that baseline, the administration's tax proposals would cause much greater revenue losses than official budget estimates show.

The distributional effects of the tax 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.

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

Note: This paper cites "10-year" revenue estimates but, because significant revenue effects occur in 2010, the 10-year values reported include both the 10-year budget window—2011-2020—and 2010.

* The authors thank Kim Rueben and Elaine Maag for helpful comments on this analysis and Jeff Rohaly, Katie Lim, and Rachel Johnson for their modeling efforts. Howard Gleckman and Len Burman contributed entries to TPC's analysis of the 2010 budget, some of which were adapted for the current analysis.

[1] 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.

Extend the "Making Work Pay" Credit through 2011

The economic stimulus act ("American Recovery and Reinvestment Act of 2009," or ARRA) created the "Making Work Pay" (MWP) tax credit, an Obama campaign proposal to offset part of the Social Security taxes paid by low- and middle-income workers. ARRA made the credit effective only for 2009 and 2010. The president proposes to extend the credit for one year through 2011 at an estimated cost of $61 billion.

MWP provides a refundable tax credit equal to 6.2 percent of earnings (the employee share of the Social Security payroll tax), up to a maximum credit of $400 for individuals ($800 for couples). Neither nonresident aliens nor taxpayers claimed as dependents by other taxpayers are eligible for the credit. Couples may claim the full $800 credit, even if only one spouse works.

The credit phases out at a rate of 2 percent of income over $150,000 for married couples filing joint tax returns and $75,000 for others. Therefore, couples with income above $190,000 and others with income above $95,000 are not eligible to receive the credit.

The credit offsets the regressivity of payroll taxes and encourages low-income people to work. Because workers in the phaseout range would face higher marginal tax rates, however, it could give those workers an incentive to work less.

MWP would reduce income taxes for three-fourths of all tax units in 2011 by an average of $385, raising average after-tax income by 0.7 percent. The credit is highly progressive: after-tax income would rise by 2.6 percent for the poorest 20 percent (quintile) of households, compared with 1 percent for the middle quintile and 0.2 percent for the top quintile.

Distribution tables

Making Work Pay Credit

2011 versus current law by cash income
2011 versus current law by cash income percentiles
2011 versus Administration baseline by cash income
2011 versus Administration baseline by cash income percentiles

Additional Resources

Stimulus Act Report Card: "Making Work Pay" Tax Credit
http://www.taxpolicycenter.org/taxtopics/conference_makingworkpay.cfm

Extend option for cash assistance to states in lieu of housing tax credits

The Low-Income Housing Tax Credit (LIHTC) provides tax incentives for the development of low-income housing. Maximum credit amounts are allocated to states based on population. LIHTC's are issued to developers through state housing agencies after a competitive application process, with more generous amounts awarded to those projects designed to house a high proportion of low-income families. Housing developers can use credits to reduce their tax own liability or they can sell the credits to other investors—most developers sell the rights to future tax credits as a way to raise capital. The credit is provided over a period of up to 10 years, with the actual amount of the credit depending on prevailing interest rates.

The subsidy for low-income housing is substantial. Developers can claim up to 30 percent of the qualified cost basis of new construction—essentially the cost of the project less the cost of the land—and up to 70 percent of the cost of rehabilitated projects. Research has shown the LIHTC to be a significant factor in the development of low-income housing over the past several decades.

The American Recovery and Reinvestment Act (ARRA) created a new way for LIHTCs to subsidize low-income housing. Instead of offering state housing agencies the right to distribute tax credits to developers, ARRA allowed states to issue cash grants directly to developers. The criteria for cash grants are the same as for tax credits.

The president's 2011 budget proposes to extend the cash grant method of subsidizing low-income housing. Under the budget proposal, states could distribute grants in lieu of unused 2009 LIHTCs or a portion of their 2010 credit allocation. This provision is temporary: states would be required to distribute the cash grants by December 31, 2012.

Substituting cash grants for tax credits helps mitigate the effects of weakened investor demand for low-income housing tax credits. With cash grants, developers can still use the subsidy for low-income housing, but don't have to partner with investors seeking to purchase the rights to LIHTCs. While the switch to cash grants is a particularly effective strategy during periods of low investor demand, the strategy could also improve the subsidy's effectiveness in periods of normal economic growth.

The net cost of this proposal is small—just $243 million over 11 years—since it simply calls for trading tax cuts in the future for cash transfers in 2010 and 2011.

Additional Resources

TaxVox: The Stimulus Act and the Limits of Tax Credits
http://taxvox.taxpolicycenter.org/blog/_archives/2009/2/26/4105482.html

Introduce Temporary Tax Credit for Increases in Payroll

The Administration is proposing a new temporary jobs credit for companies that hire new employees, expand hours, or increase wages in 2010. The credit proposal is not described in the budget documents, but a line item in the budget summary tables (Summary Table S-4, p.151) refers to "allowances for jobs initiatives" that will cost $12 billion in fiscal year 2010, another $33 billion in fiscal years 2011 and 2012, and $5 billion more in fiscal years 2013 and 2014. A White House Fact Sheet describing the proposal estimates the cost at $33 billion.

The jobs credit proposal would give employers a $5,000 tax credit against payroll taxes for net increases in employment of workers earning at least $7,000 in 2010. Employers would also receive an additional 6.2 percent credit (effectively exempting them from the employer share of Social Security payroll taxes) for increases in aggregate wages they pay in excess of inflation to employees making no more than the Social Security taxable maximum of $106,800. In order to limit the subsidy to small businesses, the total amount of credits for any single employer could not exceed $500,000 (enough to provide an incentive to hire 100 additional workers). New firms that had no employees in 2009 would be eligible for half the subsidy that existing firms would receive for increases in employment or wages. Non-profit organizations would be eligible for the credit, but government agencies at all levels would not.

Various provisions would prevent employers from receiving a subsidy for hiring more workers while reducing either total hours or wages. That would preclude, for example, replacing high-wage workers with low-wage workers or substituting more part-time workers for fewer full-time workers. To prevent such abuse, the proposal would make any business that reduces either its total employment or its payroll in 2010 ineligible for the $5,000 credit and the wage bonus and limit the maximum jobs credit amount to 25 percent of the increase in the firm's Social Security payroll wage base. Other rules would prevent businesses from renaming themselves or merging with other firms to qualify for a credit.

The credit would be based on the difference between average employment and payroll over the entire year 2010 compared with employment and payroll in 2009. But firms could claim the credit in every quarter of 2010 based on their estimated tax benefit for the entire year.

The proposal aims to accelerate the growth in employment as the economy recovers from the deepest economic slump since the great depression. The main way to increase jobs is to raise demand for goods and services, thereby spurring employers to hire new workers or expand hours of current employees to meet the demand. But in addition to raising the demand, the credit would also reduce the cost of labor in 2010, encouraging some firms either to hire more workers permanently or to accelerate hiring into 2010.

Injecting $33 billion into the economy through this additional tax cut for businesses would raise aggregate demand, but its effectiveness in raising demand depends on how quickly beneficiaries spend the tax cut. How much spending increases depends on who benefits from the tax cut. To the extent the credit would go to business owners who would increase employment without the credit, it would simply raise profits. Only new hires or wage increases that would not otherwise have occurred would benefit workers. Because workers generally have lower incomes than business owners, they are likely to spend—rather than save—a higher share of any additional income. The credit would therefore increase demand more if it spurs new employment growth rather than rewarding growth that would otherwise occurred. Higher business profits could, however, raise investments by firms who lack access to affordable credit, but these firms are unlikely to invest more unless there is demand for their products.

Reducing the cost of hiring workers could also raise employment if the lower net wage cost enables to firms to reduce their prices and sell more or if it encourages them to substitute labor for capital in production. The effect of the subsidy on labor cost is fairly modest, however. Recruiting and training costs for new workers are generally high relative to their productivity in the first year on the job, so a one-year subsidy for new workers would be a much smaller share of first year labor costs than its share of the worker's compensation. Employers typically recover these initial costs if they retain employees longer than one year, but the wage subsidy in the proposal would cease after 2010 and not lower future labor costs.

The purpose of making the credit incremental instead of providing a flat rate subsidy, such as a temporary payroll tax credit for all firms, is to raise the share of credits that provide an incentive for higher employment and wages relative to credits that go to "baseline" wages that would have been paid without an incentive. By reducing subsidies to baseline wages, an incremental credit in theory raises the "bang for the buck" – that is, the amount of additional payroll per dollar of government budgetary cost. But it is impossible to determine what firms would have been done without the credit. An incremental credit fails to provide an incentive for firms with falling demand to reduce their employment *less* quickly and provides benefits for firms experiencing rising demand that would hire more workers even with no tax incentive. Moreover, an incremental credit would have arbitrary and capricious distributional effects, rewarding firms and workers in expanding industries and regions of the country while failing to help those industries and firms still experiencing economic stagnation.

Limiting the credit to $500,000 per firm effectively limits most of the benefits and all of the incremental incentive to small firms. Other firms and their employees would benefit also, however, to the extent the credit raises aggregate demand and employment through increased spending by those newly employed and business owners with increased profits. But the limit would reduce the cost-effectiveness of the credit, because all firms otherwise increasing jobs by more than 100 workers would receive the full maximum credit without any incentive to hire more workers.

Making the credit available only for 2010 increases in jobs could encourage some firms to hire workers late in 2010 who they otherwise would have hired in 2011. The acceleration of jobs would not directly increase employment in 2011 and beyond, but could indirectly raise jobs in 2011 if the new hires help accelerate the economic recovery by spending some of their increased wages.

Preventing abuse would require complex rules that might, in turn, deter firms from responding to the incentive or lead them only to calculate their eligible benefit after the fact. Evaluations of the 1977 "new jobs tax credit" and how it came about found that most firms were either unaware of the credit or did not respond to it. Research based on a Department of Labor survey found that only 6 percent of firms who knew about the credit said that it prompted them to hire more workers. Firms that were aware of the credit, however, increased employment about 3 percent more than other firms. This may reflect a positive incentive effect or, alternatively that firms who were planning to hire additional workers were more likely to find out about the credit.

Some economists view the 1977 experience favorably and believe an incremental refundable jobs credit that corrects some of the flaws of the 1977 law could be very a cost-effective way of creating new jobs. These analysts, however, criticize the cap on each firm's increased payroll in the 1977 legislation, which is also a feature of the new proposal.

In summary, the effect of this proposal on employment is very uncertain. In theory, an incremental jobs credit could be a cost-effective way of raising employment in the short run and some research suggests that the 1977 credit did increase jobs, although the evidence on that is far from conclusive. The effectiveness of the subsidy depends greatly on both the details of the proposal, still to be finalized, and on how employers perceive its potential benefits when making hiring decisions.

Additional Resources

Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit," Economic Policy Institute Briefing Paper #248, October 2009. http://www.epi.org/publications/entry/bp248/

Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," January 2010. http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf

Howard Gleckman, "Will a Jobs Tax Credit Create Jobs and Save Democrats?" *TaxVox*, October 13, 2009. http://taxvox.taxpolicycenter.org/blog/_archives/2009/10/13/4347776.html

Jeffrey M. Perloff and Michael L. Wachter. "The New Jobs Tax Credit: An Evaluation of the 1977-78 Wage Subsidy Program." *American Economic Review* 69-2, pp. 173-179. May 1979. http://ideas.repec.org/a/aea/aecrev/v69y1979i2p173-79.html

Emil M. Sunley "A Tax Preference is Born: A Legislative History of the New Jobs Tax Credit." In Henry J. Aaron and Michael J. Boskin, editors, *The Economics of Taxation*, pp. 391-408. Washington DC: The Brookings Institution. 1980. http://taxvox.taxpolicycenter.org/sunley.pdf

Extend Temporary Increase in Expensing for Small Business

Under Section 179 of the Internal Revenue Code, businesses may expense, or immediately deduct, the first $25,000 of investments in machinery and equipment. The amount of qualifying investment eligible for the deduction decreases dollar for dollar for amounts in excess of $200,000, so that businesses investing more than $225,000 receive no immediate deduction.

In 2003, Congress increased the amount of Section 179 expensing to $100,000 and raised the start of the phase-out range to $400,000 for 2003, 2004 and 2005. For years after 2003, the limits were indexed for inflation. The American Jobs Creation Act of 2004 extended the limits through 2007. The economic stimulus package that Congress enacted in January 2008 raised the limits for tax year 2008 to $250,000 and $800,000. The American Recovery and Reinvestment Act of 2009 extended the 2008 limits through the end of tax year 2009.

Section 179 Limits under Current Law			
Year(s)	Expensing limit	Start of phase-out	End of phaseout
2007	$125,000	$500,000	$625,000
2008-2009	$250,000	$800,000	$1,050,000
2010	$125,000	$500,000	$625,000
2011 and later	$25,000	$200,000	$225,000

The president would extend the 2008 and 2009 limits to qualified property placed in service in 2010. While the increases in expensing enacted in 2003, extended in 2004, and increased and extended in 2008 and 2009 are scheduled to expire at the end of 2010, the Administration's tax receipt baseline assumes permanent extension of current law rules for 2010 (a maximum deduction of $125,000 and a phase-out level of $500,000 both indexed for inflation). By placing the extension of 2010 law in the baseline, the President removes the cost from the PAYGO rules.

Proposed Section 179 Limits in 2011 Budget			
Year(s)	Expensing limit	Start of phase-out	End of phaseout
2010	$250,000	$800,000	$1,050,000
2011 and later	$125,000	$500,000	$625,000

Section 179 expensing reduces the cost of capital for businesses that use qualifying machinery and equipment and reduces compliance costs by eliminating the need to apply tax depreciation rules and keep track of the adjusted basis of assets. It produces little benefit for those whose capital consists mainly of structures or inventory and no benefit for businesses whose investment exceeds the phase-out limit ($1,050,000 in 2010 under the President's proposal, for example). By providing an immediate deduction for the entire cost of equipment, expensing generates a larger benefit for longer-lived equipment than for shorter-lived equipment, such as computers, that could otherwise be amortized over three years.

It is hard to know how much this proposal would boost the economy. There have been no studies on the effect of Section 179 expensing on the long-term level or timing of investment. Lower capital costs should encourage some additional investment, but much of the tax benefit would go to investments that would have been undertaken even if taxpayers had to depreciate them over longer periods. A temporary tax incentive could accelerate some investment. However, since generous expensing rules have been in place for several years, some capital purchases that may otherwise have been accelerated already have occurred.

Some believe that expensing should be the rule for all investments, not just those made by small businesses. Expensing is equivalent to exempting the normal return on investment and would be the norm if the tax base were consumption rather than income. However, enacting expensing alone, without making other conforming changes, such as eliminating deductions for interest expense, can create inefficient arbitrage opportunities. Under such a system, investments could be profitable even if they earned sub-par returns because of the tax deductions that they generate. This is a primary concern about expanding the scope of small business expensing provisions. The gains from simplicity have to be weighed against the costs of expanding tax-shelter opportunities.

While the proposal is designed to be temporary, the higher limits originally enacted in 2003 were extended in 2005 and then raised in 2008 and 2009. If taxpayers believe the higher limits in 2010 will be permanent, their short-term stimulus effect would be smaller because taxpayers would have no incentive to accelerate the timing of investments.

Extension of Bonus Depreciation

To determine taxable income, businesses subtract expenses from their receipts. While some business expenses are for items that are entirely used up during the year (e.g., materials and labor), other business expenses are for durable goods that last for many years. The expense for investment in capital equipment (e.g., tractors, computers and wind turbines) occurs over many years as the value of the investment is used up or depreciated. Under current law, businesses calculate taxable income by deducting capital costs over time according to fixed depreciation schedules.

Over the past decade, Congress has repeatedly allowed faster depreciation of capital assets to stimulate business investment by providing a "bonus" depreciation allowance in the year the asset is purchased. In 2002, Congress let businesses claim a "bonus" depreciation allowance equal to 30 percent of the cost of investment purchased between September 10, 2001, and September 11, 2002. The following year, Congress raised the deduction to 50 percent of investments purchased after May 5, 2003, and before January 1, 2005. The 2008 economic stimulus package renewed the 50 percent deduction again, this time for investments made during 2008. The American Recovery and Reinvestment Act of 2009 renewed the 50 percent deduction for investments made during 2009. Not all property qualifies for bonus depreciation. Qualified investments include tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property. Furthermore, only new property qualifies for bonus depreciation.

To stimulate investment, the president would renew bonus depreciation once again. Businesses would receive a bonus depreciation allowance equal to 50 percent of the cost of qualifying investments acquired in 2010. Businesses would deduct the remaining 50 percent of the investment's cost according to regular depreciation schedules.

Accelerating depreciation deductions does not increase the total amount a company can write off for a given investment. Instead, it allows businesses to deduct more of the cost now and less in the future. That reduces their current tax liabilities at the cost of higher taxes later. Since deductions today are worth more to taxable businesses than deductions in the future, the provision lowers the effective tax rate on new investment making investment more attractive. Lower taxes also increase cash flow.

Economic research suggests that bonus depreciation enacted in 2002 and 2003 had relatively modest effects. There are at least three reasons why: Businesses may have expected that Congress would extend the provisions, thus blunting their incentive to speed up investment. It takes time for businesses to make major investments, making it hard to fit them into specified time periods. Finally, many businesses may have had too little income to offset with these additional tax benefits, a problem that is especially acute during economic downturns.

As recent history has made clear, Congress can turn bonus depreciation on and off as economic circumstances dictate. Paradoxically, that flexibility could render the policy less effective. If businesses expect that Congress will extend the provision as it has in the past, they may not accelerate their investment. As a result, the benefits of the provision may accrue primarily to investment that would have been made anyway, thereby undercutting the cost effectiveness of the tax incentive.

The revenue loss of the provision is front-loaded. Bonus depreciation decreases tax payments in the first years but increases payments in future years relative to current law. The administration estimates that the provision would lose revenue in 2010 and 2011 and then raise revenue in every subsequent year through 2020. The proposal would boost revenues by $20 billion during the 2011-2020 budget window but would lose an estimated $22 billion in 2010. The net cost of $1 billion over the 2010-2020 period would be even higher if the future revenue gains were discounted at a positive rate.

Additional resources

Congressional Budget Office. 2008. *Options for Responding to Short-Term Economic Weakness.* Washington, DC: Congressional Budget Office. http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf

Expand the Earned Income Tax Credit

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 for two years, thus raising the maximum credit for families with three or more children from $5,036 to $5,666 in 2010. The act also increased the phaseout income levels for all married couples filing a joint tax return (regardless of the number of children) to $5,000 above the thresholds for single filers. The president proposes to extend the higher credit rate for one year and to make permanent the 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.

Additional Resources

Tax Policy Briefing Book: Taxes and the Family: What is the earned income tax credit?
http://www.taxpolicycenter.org/briefing-book/key-elements/family/eitc.cfm

Stimulus Act Report Card: Increase in Earned Income Tax Credit
http://www.taxpolicycenter.org/taxtopics/conference_EITC.cfm

† The president would include the $5,000 higher phaseout threshold in his budget baseline. In his 2010 budget, the president proposed indexing the $5,000 amount for inflation. Budget materials for 2011 do not address the question of indexing that parameter.

Permanently Expand Refundability of the Child Tax Credit

Families with children under age 17 can claim a Child Tax Credit (CTC) of up to $1,000 per child. If the credit exceeds taxes owed, families can receive some or all of the balance as a refund, known as the Additional Child Tax Credit (ACTC). The ACTC is limited to 15 percent of earnings above a threshold that is indexed to inflation. The economic stimulus act ("American Recovery and Reinvestment Act of 2009") temporarily set that threshold at $3,000 so that families would start getting at least a partial credit at lower earnings levels than they did under prior law ($12,550 in 2009). The president proposes to make the lower threshold permanent. Lowering the threshold for refundability would encourage low-income workers to work more by increasing their after-tax wage but the effect would likely be small.

The president made a similar proposal in his 2010 budget, where he also proposed to discontinue indexing the threshold for inflation. Budget materials released to date do not address the issue. Not indexing the threshold would cause the threshold to decrease in real terms over time, making more families eligible for the refundable credit and increasing the size of the credit for many families.[*]

Additional Resources

Tax Policy Briefing Book: Taxes and the Family: What is the child tax credit? http://www.taxpolicycenter.org/briefing-book/key-elements/family/ctc.cfm

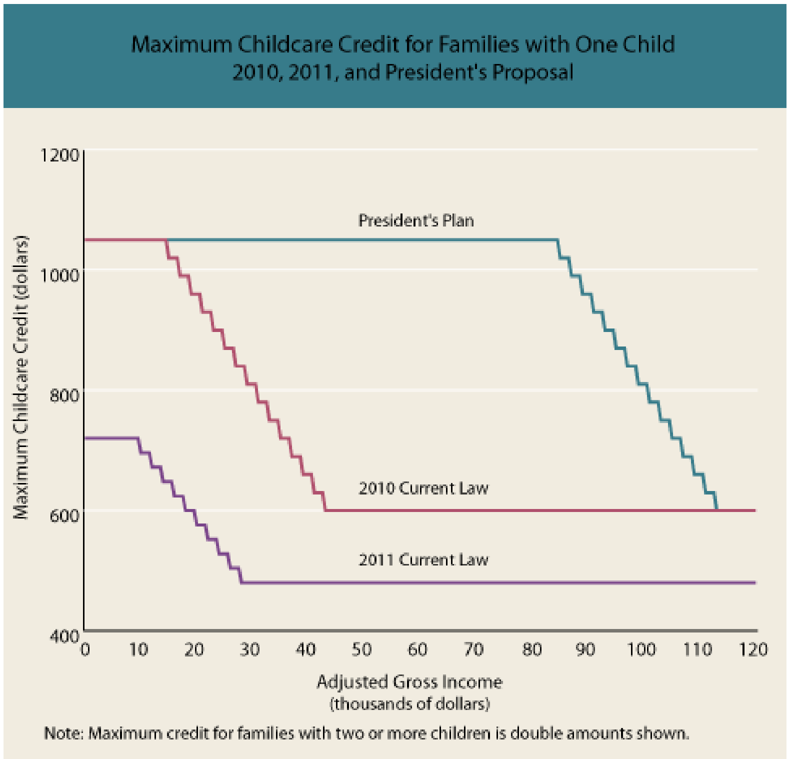
Stimulus Act Report Card: Increase Eligibility for the Refundable Portion of the Child Tax Credit http://www.taxpolicycenter.org/taxtopics/senate_refundable_child.cfm

[*] The president would include the increased refundability of the child tax credit in his budget baseline.

Expand the Child and Dependent Care Tax Credit

The Child and Dependent Care Tax Credit (CDCTC) provides a credit of between 20 percent and 35 percent of up to $3,000 ($6,000 for two or more children) of childcare 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 non-refundable—that is, it can only reduce a family's income tax liability to zero; any additional credit is lost.

Unless Congress extends EGTRRA beyond its scheduled expiration at the end of 2010, the CDCTC will revert to its previous 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 ($6,000 for two or more children) to $2,400 ($4,800). 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 $85,000 the income threshold above which the credit rate phases down. That rate would decrease by 1 percentage point for each $2,000 of income over that threshold until it hits a minimum of 20 percent for families with income over $113,000. For families with income between $28,000 and $85,000, 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 $10,000 and $28,000 or between $85,000 and $113,000 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, for whom the credit would offer the largest percentage increase in net wage and thus have the greatest impact on employment.

Compared against the credit provided in 2010, the proposal would increase the average CDCTC by about a third—from $513 to $700—at a cost of nearly $1.2 billion in lost revenue annually. Families with incomes under $30,000 would receive almost no benefit from the proposed change. Though they comprise nearly a third of all families with children, they receive less than 5 percent of benefits. About 85 percent of families with incomes between $30,000 and $50,000 who get the credit would see their taxes drop—by an average of $250. But most of the gains would go to families with income between $50,000 and $100,000. Virtually all of the more than 2 million families in that income range who claim the credit would see their taxes fall by an average of $360. Those families, who comprise about one-quarter of all families with children, would get nearly two-thirds of the tax savings from the proposed change.

Additional Resources

Tax Policy Briefing Book: Key Elements of the U.S. Tax System: Taxation and the Family: How does the tax system subsidize child care expenses?
http://www.taxpolicycenter.org/briefing-book/key-elements/family/child-care-subsidies.cfm

Quick Facts: Child and Dependent Care Tax Credit (CDCTC)
http://www.taxpolicycenter.org/press/quickfacts_CDCTC.cfm

‡ The changes noted in the text are measured relative to credit amounts in 2011 with expiration of EGTRRA. Compared against the credit in 2010, the maximum gains would go to families with income between $43,000 and $85,000; families with income between $15,000 and $43,000 or between $85,000 and $113,000 would see smaller increases.

Make Permanent the American Opportunity Tax Credit

The economic stimulus act ("American Recovery and Reinvestment Act of 2009") established for two years the "American Opportunity" tax credit (AOTC) as a replacement for the Hope credit. The president proposes to make the credit permanent and index for inflation both the maximum expenditures eligible for the credit and the income thresholds above which the credit phases out. 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 (double the two years allowed for the Hope credit) for students attending school at least half time. The maximum credit would thus be $2,500 a year. As was the case for the Hope credit, taxpayers could not claim the credit for any expenses paid using funds from other tax-preferred vehicles such as 529 plans and Coverdell Savings Accounts, nor could they use more than one of the AOTC, the lifetime learning credit, and the deduction for tuition expenses for a student in a given year.

Forty percent of the AOTC is refundable and therefore available to households with little or no tax liability. The maximum amount of refundable credit is thus $1,000, which would be indexed for inflation under the president's proposal.

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.

The larger, refundable credit would extend educational assistance to low-income students, making it easier for them to afford college and thus encouraging attendance, but the credit's phaseout would boost marginal tax rates for affected taxpayers. Because most students would qualify for the credit, colleges might react by raising tuition, thus reducing the credit's value for students. 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.

Additional Resources

Stimulus Act Report Card: "American Opportunity" Tax Credit http://www.taxpolicycenter.org/taxtopics/conference_american_opportunity.cfm

Tax Topics: Education Tax Incentives http://www.taxpolicycenter.org/taxtopics/Education-Tax-Incentives.cfm

Expand saver's credit and require automatic enrollment in IRAs

Under current law, low- and middle-income taxpayers may claim a saver's credit of up to $1,000 ($2,000 for couples) if they contribute to retirement savings plans. The credit equals the credit rate times up to $2,000 of contributions to IRAs, 401(k)s, or certain other retirement accounts by each taxpayer and spouse. The credit rate for 2010 depends on income and tax filing status as shown in the following table. (For 2010, couples filing jointly must have income below $55,500, heads of household income below $41,625, and other tax filers income below $27,750 to claim any credit.) The credit is not refundable and therefore has limited value for people with little or no income tax liability.

Saver's Credit Rates by Tax Filing Status and Adjusted Gross Income

Credit Rate (percent)	Income Tax Filing Status		
	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
50	Up to $33,500	Up to $25,125	Up to $16,750
20	$33,500 - $36,000	$25,125 - $27,000	$16,750 - $18,000
10	$36,000 - $55,500	$27,000 - $41,625	$18,000 - $27,750
No credit	Over $55,500	Over $41,625	Over $27,750

Source: "IRS Announces Pension Plan Limitations for 2010, " IR-2009-094, October 15, 2009 at http://www.irs.gov/newsroom/article/0,,id=214321,00.html.

The president proposes to make the saver's credit refundable as a 50-percent credit up to $500 in contributions per individual (indexed for inflation), making the maximum credit $250 per individual. The full credit would go to families with income below $65,000 ($48,750 for heads of household and $32,500 for singles and married couples filing separately). The credit would phase out when income exceeds those limits: the maximum credit would be reduced by 5 percent of income over the relevant limit. In addition, the president proposes to make the credit more like a matching contribution on a 401(k) by allowing it to be automatically deposited into the saver's retirement account.

The government would effectively pay half the cost of up to $1,000 deposited to a retirement account each year for all eligible households. For example, a family that puts $800 aside in a retirement account would receive a $400 tax credit, lowering the net cost of the contribution to $400. Turning the currently nonrefundable saver's credit into a refundable credit would encourage low-income households to save more by boosting their effective return to saving. The phaseout of the credit would, however, modestly raise effective marginal tax rates for some middle-income taxpayers with potentially adverse behavioral effects on work effort and saving.

In addition, while the president's proposal expands the number of Americans eligible for the credit, it also reduces the maximum benefit of the credit for some households.

The president also 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 president's 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 be required to enroll employees in a direct-deposit IRA account unless the worker opts out. The default contribution rate would be set at 3 percent of compensation, and contributions would automatically be invested in standard, low-cost investments. Furthermore, the default option would be a Roth IRA, funds for which come from after-tax income, as opposed to a deductible IRA, which is funded from pretax income.

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, for not more than two years, to help small businesses cover the costs of automatic enrollment. In addition, the proposal would double the tax credit for small businesses starting new employee retirement plans from $500 to $1,000, available for a maximum of three years.

Expanding the saver's credit would reduce revenues by $29.8 billion over 11 years, while requiring automatic enrollment in IRAs and doubling the retirement plan startup credit for small businesses would cost $10.4 billion. 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 2011-2020 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 http://www.taxpolicycenter.org/UploadedPDF/1001312_auto_enroll.pdf

Eliminate the Advance Earned Income Tax Credit

Low-income workers with children may choose to receive the Earned Income Tax Credit (EITC) throughout the year as Advance Earned Income Tax Credit (AEITC). The AEITC comes as a regular addition to take-home pay through reduced withholding or, for those with too little withholding, added pay. In 2010, the maximum AEITC a family may get is $1,830. Few eligible workers opt to receive the AEITC: less than 2 percent of workers who claim the EITC on their tax returns get advance payments. Surveys indicate that most eligible workers choose not to claim the advance credit because they prefer to get large refunds when they file their tax returns or worry about having to repay excess advance payments.

The president proposes to eliminate the AEITC starting in 2011 on the argument that few people use it and the program has high error rates. OMB Director Peter Orszag asserted, “This budget proposes eliminating it, not because we don't support work incentives for low- and moderate-income workers, but rather because that program simply does not work well.” (February 26, 2009, press briefing http://www.whitehouse.gov/the_press_office/Press-Briefing-by-OMB-Director-Peter-Orszag-and-CEA-Chair-Christina-Romer/)

Additional Resources

“Giving Up on the Advanced Earned Income Tax Credit,” *TaxVox*, March 4, 2009
http://taxvox.taxpolicycenter.org/blog/_archives/2009/3/4/4112093.html

Stimulus Act Report Card: Increase in Earned Income Tax Credit
http://www.taxpolicycenter.org/taxtopics/conference_EITC.cfm

Tax Increases on High-Income Taxpayers

Under current law, the 2001 and 2003 tax cuts nearly all expire in 2011, returning the individual income tax 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 2011, the tax cuts will become permanent. From that baseline, he would increase taxes in 2011 for high-income taxpayers—couples with income over $250,000 and single people with income above $200,000. Specifically, for those taxpayers, he would raise the top two tax rates back to their pre-2001 levels (changing the income threshold for the next-to-highest rate to protect taxpayers below the thresholds), reinstate the personal exemption phaseout and the limitation on itemized deductions, and impose a 20 percent tax rate on long-term capital gains and qualified dividends. He would also eliminate the lower tax rate on capital gains on assets owned more than five years.

Those tax increases would essentially leave income tax rates for high-income taxpayers at the levels scheduled after 2010 under current law. People 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 2001-2003 tax cuts expire. 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 2001-2003 tax cuts would virtually all expire after 2010, these proposals would increase income taxes for about 3.4 percent of all taxpayers with most of the increase toward the upper end of the income distribution. About one-fifth of those in the top quintile and nearly 60 percent of those in the top 1 percent would experience a tax increase.

Distribution tables

Tax increases on high-income taxpayers

2012 versus current law by cash income
2012 versus current law by cash income percentile
2012 versus Administration baseline by cash income
2012 versus Administration baseline by cash income percentile

- **Reinstate 39.6 percent rate in 2011**

The president proposes to raise the top tax rate in 2011 from 35 percent to 39.6 percent.

- **Increase the 33 percent tax rate to 36 percent and change the thresholds for that tax bracket in 2011.**

The president proposes to return the 31 percent tax rate to its pre-2001 level of 36 percent and change the lower bound for taxable income subject to that rate. 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 plus twice the personal exemption.[§] For single filers, the threshold would start at $200,000 minus the sum of the standard deduction for single filers plus the personal exemption.[**]

Increasing the threshold would reduce the current 33 percent tax rate on income between the old and the new thresholds to 28 percent, reducing the tax liability of people with taxable income in that range. That tax reduction would also offset some or all of the tax increase for people with taxable income above the new thresholds. For example, the Tax Policy Center projects that the 2011 threshold for the next to the highest tax bracket for married couples filing jointly will be $212,600 under the budget's extend baseline but would increase to $235,450 under the president's proposal (see the tax rate table). People with taxable income between the two thresholds would see their tax rate on that income fall from 33 percent to 28 percent under the proposal, reducing their regular tax liability by up to $1,142. Everyone with taxable income at or above the new threshold who does not pay the alternative minimum tax (AMT) would get the maximum tax cut on income in that range.[††] Those with taxable income above the new threshold would incur a tax increase above the threshold because the top two tax rates would increase. The tax savings from the wider 28 percent bracket would fully compensate for the rate increases for couples with taxable income up to $273,533 and single filers with income up to $226,383, giving those taxpayers a net tax cut.[‡‡] People with income above those levels would see their tax liability rise.

[§] The Treasury Department description of this proposal does not say at what income the 36 percent bracket would begin for married couples filing separately. In keeping with other provisions in the individual income tax, however, that threshold would be half of the threshold for married couples filing jointly.

[**] A similar calculation would presumably apply in setting the tax bracket's threshold for heads of household – that is, the threshold would equal $200,000 minus the standard deduction for heads of household and one personal exemption. The Treasury Department's description of the proposal says only that the threshold applies "for single filers". Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 128. See further discussion below.

[††] Taxpayers who owe AMT would not get a tax cut under the proposal since their tax liability is determined by the AMT, not their regular tax liability. A significant number of taxpayers with income in the affected ranges, particularly married couples, are on the AMT.

[‡‡] The widening of the 28 percent bracket would cut the tax rate for married couples filing jointly from 33 percent to 28 percent on up to $22,850 of taxable income, yielding a maximum tax saving of $1,142.50. The increase in the tax rate on additional income from the 33 percent to 36 percent would raise tax liability by an equivalent amount when income equals $273,533. (The increase is 3 percent of taxable income over $235,450) = .03 times $38,083 = $1,142.50.)

2011 Tax Rates under Extended Baseline and as Proposed in 2011 Budget

Taxable Income		Marginal Tax Rate	
Over	But not over	Extended Baseline	Budget Proposal
Single			
$0	$8,500	10%	10%
$8,500	$34,550	15%	15%
$34,550	$83,700	25%	25%
$83,700	$174,650	28%	28%
$174,650	$194,050	33%	28%
$194,050	$379,650	33%	36%
$379,650	---	35%	39.6%
Married Filing Jointly			
$0	$17,000	10%	10%
$17,000	$69,100	15%	15%
$69,100	$139,500	25%	25%
$139,500	$212,600	28%	28%
$212,600	$235,450	33%	28%
$235,450	$379,650	33%	36%
$379,650	---	35%	39.6%
Head of Household			
$0	$12,150	10%	10%
$12,150	$46,300	15%	15%
$46,300	$119,550	25%	25%
$119,550	$193,600	28%	28%
$193,600	$214,750	33%	28%
$214,750	$379,650	33%	36%
$379,650	---	35%	39.6%

Tax Rate would decrease

Tax Rate would increase

That situation would reverse for heads of household, for whom the threshold for the new 36 percent tax bracket would fall rather than rise (assuming the threshold is set in a manner similar to that for singles and married couples filing jointly).[§§] Heads of household with taxable income between $181,350 and $191,600 would see the tax rate on income in that range rise from 28

§§ TPC assumes that the 2009 threshold for the proposed 36 percent tax bracket would equal $200,000 minus the standard deduction for heads of household minus one personal exemption. The 2011 threshold would be that threshold indexed for inflation between 2009 and 2011.

percent to 36 percent, boosting their tax bill up to $180. Every head of household with taxable income above $191,600 would experience that $180 tax increase in addition to the additional tax due to raising the current 33 and 35 percent rates to 36 and 39.6 percent, respectively.

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

High-income taxpayers face phaseouts of their personal exemptions and itemized deductions as their income exceeds specified levels. The 2001 tax act scheduled a gradual phased elimination of the phaseouts beginning in 2006 with complete elimination in 2010. Under current law, the phaseouts revert to their previous levels after 2010. The president proposes to eliminate the phaseouts and then reinstate them for high-income taxpayers in 2011.

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 phaseout table).

Personal Exemption Phaseout (PEP), 2011

	Budget Proposal		Current Law	
Filing Status	AGI Begin Phaseout	AGI Maximum Phaseout	AGI Begin Phaseout	AGI Maximum Phaseout
Married, Filing joint or surving spouse	$254,450	$376,950	$254,650	$377,150
Heads of household	$203,550	$326,050	$212,200	$334,700
Single	$203,550	$326,050	$169,750	$292,250
Married, filing separate	$127,200	$188,450	$127,300	$188,550

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 $169,750 in 2011 ($84,850 for married couples filing separately)—is indexed for inflation.

The president proposes to restore both PEP and Pease in full in 2011. The threshold for the phaseouts would begin at 2009 levels of $250,000 for couples[***] and $200,000 for other taxpayers, with both values indexed for inflation. TPC estimates that 2011 thresholds would be $254,450 and $203,550 for couples and others, respectively. Personal exemptions would thus phase out for couples with income between $254,450 and $376,950 and for others with income between $203,550 and

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

$326,050.[†††] Taxpayers would have their itemized deductions reduced in 2011 by 3 percent of their income over $203,550 (for single filers; the threshold would be $254,450 for couples filing jointly[‡‡‡]) but not by more than 80 percent. Both phaseouts would increase marginal tax rates for taxpayers in the affected income ranges.

Additional Resources

Tax Policy Briefing Book: Income Tax Issues: How do phaseouts of tax provisions affect taxpayers? http://www.taxpolicycenter.org/briefing-book/background/issues/phaseouts.cfm

- **Impose 20 percent rate on capital gains and dividends**

Under current law, long-term capital gains (on assets held at least a year) and 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. Tax rates on both long-term gains and dividends are scheduled to revert to their pre-2003 levels in 2011: 20 percent on gains (10 percent for taxpayers in the 15 percent bracket and below)[§§§] and regular tax rates (as high as 39.6 percent) on dividends. The president would make permanent the current maximum 15 percent rate on both kinds of income but would raise the rate to 20 percent for high-income taxpayers starting in 2011. The proposal would define high-income taxpayers as those in the top two tax brackets – couples with 2011 taxable income above $235,450 and single people with income over $194,050, with both values indexed for inflation.

The higher rate on capital gains and dividends would increase marginal tax rates on capital income for high-income taxpayers and could induce them to change their investment behavior. Affected taxpayers, anticipating the higher tax on long-term gains in the future, would likely realize more such gains in 2010 and less in 2011. Corporations might shift payment of dividends forward into 2010 and could reduce future dividends in favor of more retained earnings.

Additional Resources

Tax Policy Briefing Book: Key Elements of the U.S. Tax System: Capital Gains and Dividends http://www.taxpolicycenter.org/briefing-book/key-elements/capital-gains/index.cfm

††† The values for married couples filing separately would be half those for joint filers.

‡‡‡ The proposal does not say what the Pease thresholds would be for heads of household or for married couples filing separately. The current threshold for heads of household is the average of the thresholds for singles and married couples filing jointly; that for married couples filing separately is half that for couples filing jointly. If the same relationships applied to the 2010 budget proposals, the 2011 thresholds for heads of household and married filing separately would be $214,750 and $117,725, respectively.

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

Limit the value of itemized deductions to 28 percent

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 itemized deductions is that allowable expenses reduce the taxpayer's ability-to-pay and should therefore not count in taxable income.

The president proposes limiting the value of deductions to no more than 28 percent starting in 2011. That limit would increase taxes for taxpayers whose tax rate exceeds 28 percent—those who would face 36 percent and 39.6 percent tax rates in 2011.

This change would interact with Pease (the limitation on itemized deductions). Relative to having neither provision, the 28 percent cap on the value of deductions and Pease would combine to 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.

The tax treatment of itemized deductions reduces the after-tax cost of allowed expenditures. For example, a taxpayer in the 35 percent bracket who donates to a charity effectively pays only 65 cents for each dollar she gives because giving a dollar reduces her tax bill by 35 cents (35 percent of the deductible one-dollar donation). That lower after-tax price of giving provides the taxpayer with an incentive to give more to charitable causes than she would in the absence of the deduction and consequent tax savings. The same outcome obtains for other itemizable spending; 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.

The 2005 President's Advisory Panel on Federal Tax Reform[****] 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.

The proposal would limit the value of deductions for about one-third of taxpayers in the top income quintile in 2012, raising their taxes by an average of almost $1,200. About 85 percent of taxpayers in the top 1 percent would pay more tax, an average increase of more than $15,000.

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

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 Administration baseline by cash income

2012 versus Administration baseline by cash income percentiles

Additional Resources

Tax Policy Briefing Book: Income Tax Issues: What is the difference between tax deductions and tax credits? http://www.taxpolicycenter.org/briefing-book/background/issues/credits.cfm

President's Advisory Panel on Federal Tax Reform, *Final Report*, November 2005 http://www.taxpolicycenter.org/taxtopics/upload/Tax-Panel-2.pdf

"Limit the Tax Benefit of Itemized Deductions to 15 Percent," Congressional Budget Office, *Budget Options*, February 2007, p. 270. http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf

Eliminate Capital Gains Taxes on Investments in Small Business Stock

The Omnibus Reconciliation Act of 1993 allowed 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 by a non-corporate taxpayer. 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) temporarily raised the exclusion to 75 percent for stock issued between February 17, 2009 and January 1, 2011. 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).

A portion of the excluded gain is an AMT preference item (added to the AMT measure of income and subject to the alternative tax). The AMT preference is currently 7 percent of the excluded gain, but is scheduled to increase after 2010 to 28 percent of the excluded gain on stock acquired since 2001 and to 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.

The result of all these complicated rules is that new stock issued by certain small businesses is generally taxed at one-quarter of the taxpayer's marginal rate (up to a maximum of 28 percent) as long as it is held for at least five years. Thus, the maximum rate for qualifying small business stock is 7 percent. After 2010, the exclusion returns to 50 percent, 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 proposes to fully exempt capital gains on qualifying small business stock—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.

Additional Resources

Tax Policy Briefing Book: Capital Gains: How are they taxed?
http://www.taxpolicycenter.org/briefing-book/key-elements/capital-gains/how-taxed.cfm

“The Complexity of Capital Gains Taxation,” *TaxVox*, February 24, 2009
http://taxvox.taxpolicycenter.org/blog/_archives/2009/2/24/4103366.html

Make 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, thirteen times. The president would make the R&E tax credit permanent effective as of January 1, 2010.

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 12 percent (14 percent for 2009) 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 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 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, however, 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, however, would give a more realistic picture of future costs; given the repeated extension of the credit, the sunset provision leads to an understatement of its true cost. Critics of the credit acknowledge the social benefits of research, but point out that not all qualifying research and development generates social benefits in excess of private returns. 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

Impose 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 December 31, 2009, the TARP program had made gross purchases totaling more than $450 billion. Direct capital injections into financial institutions accounted for approximately half of that amount; most of the rest provided support for the automakers and insurance corporation AIG. After accounting for the roughly $150 billion repaid, the TARP program has net holdings of approximately $300 billion. Recent estimates by the Treasury put the expected fiscal cost of the TARP program at around $120 billion.

The president proposes to assess a 0.15 percent fee on the 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 liabilities; foreign firms would be assessed based on the consolidated liabilities of their U.S. subsidiaries. The base would exclude certain liabilities required for regulatory purposes, such as FDIC insured deposits and insurance policy reserves. Other low-risk liabilities, such as repurchase agreements based on U.S. Treasury securities, would receive special consideration. The fee would take effect July 1, 2010 and remain in effect for 10 years or until revenues from the fee fully recoup losses from the TARP program, whichever is longer.

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 payment for the government’s support during times of widespread financial distress. It is unlikely, however, to discourage reckless lending behavior (such as the subprime mortgage loans at the heart of the current crisis), as expected excess returns on such lending would far exceed the fee.

The Administration estimates that the proposal would raise $90 billion over the next 10 years and increase tax liability for affected firms by as much as 20 percent. 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). Significant tax avoidance behavior is unlikely because the fee would affect relatively few firms and public attention would be high.

Additional Resources

TARP Transaction Reports, FinancialStability.gov
http://www.financialstability.gov/latest/reportsanddocs.html
White House, “Financial Crisis Responsibility Fee Fact Sheet,” January 14, 2010.
http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf

Codify "Economic Substance" Doctrine

Legislative efforts to address the problem of abusive tax shelters have centered on whether to codify, or write into law, an "economic substance" rule or doctrine. The economic substance doctrine says that a transaction must have a meaningful economic purpose or investor risk to be legitimate. The president proposes to clarify such a doctrine and impose a new 30 percent penalty on understatement of tax for transactions that lack economic substance. A transaction would meet the "economic substance" doctrine only if it changes in a meaningful way (apart from any federal tax effect) the taxpayer's economic position and the taxpayer has a substantial purpose (other than a federal tax purpose) for undertaking the transaction.

In recent years, courts have consistently rejected a variety of tax shelters because the transactions lacked economic substance. They have, however, articulated different standards for determining the presence of economic substance. Advocates of defining economic substance in the Internal Revenue Code believe this would lead to greater certainty and uniformity in the definition of allowable transactions than current common law interpretations and thereby more effectively constrain tax sheltering behavior. Courts would still, however, have to interpret when a transaction falls within the intent of the statutory language. The estimated revenue gain is probably based on the assumption that the increase in penalties when a transaction lacks economic substance, as defined in the provision, will deter aggressive behavior and not on the assumption that the legislative language will make the IRS more successful in the courts.

Taxpayer representatives fear that rigid application of a statutory economic substance doctrine will lead to the denial of certain tax benefits which are currently permitted. Others oppose a legislated definition because it may add little to what the courts are already doing and could provide a roadmap for taxpayers to design transactions that satisfy the doctrine. They believe that today's various court interpretations constrain tax shelters more effectively than a more uniform statutory rule.

Increase Certainty With Respect to Worker Classification

For over 30 years (under Section 530 of the Revenue Act of 1978—not in the Internal Revenue Code) the Internal Revenue Service has been prohibited from issuing guidance regarding the classification of workers as either employees or independent contractors. In addition, a service recipient may continue to treat a worker as an independent contractor, even though he may actually be an employee, as long as the service recipient has a reasonable basis for doing so and certain other requirements are met. The Internal Revenue Service may not reclassify either this worker or new hires in the same position.

Misclassification may deny the worker certain benefits to which employees are entitled such as unemployment insurance and workmen's compensation. Avoiding these obligations may provide a competitive advantage to employers who have misclassified workers. The situation also increases opportunities for tax avoidance because employers need not withhold taxes on payments to independent contractors.

The proposal would give the IRS authority to require prospective reclassification of worker and to issue general guidance as the proper classification of workers under common law standards. The provision would be effective on enactment subject to a transition rule for workers subject to the existing special provision.

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 two largest tax preferences are:

- *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 $5.1 billion between 2011 and 2015.[‡‡‡‡]
- *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 5 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 $4.0 billion between 2011 and 2015.

Other tax expenditures for fossil fuels listed in the budget (and their 2011-15 costs) include: 2-year amortization of geological and geophysical expenditures ($0.9 billion), capital gains treatment of royalties on coal ($0.4 billion), and an exception from the passive loss limitation for working interests in oil and gas properties ($0.1 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 also provides a much broader subsidy for domestic US 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 $76.7 billion for all qualified domestic production between 2011 and 2015. Production from domestic oil and gas wells and domestic coal mines benefits from this deduction, but no more than any other qualified domestic production.

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†††† The Tax Expenditure chapter in the Analytical Perspectives section of the federal budget displays the costs of these tax preferences.

‡‡‡‡ The tax expenditure estimates reported here cover only five years—2011-2015—because estimates for the full ten-year budget window are not available.

The Administration proposes to eliminate special tax benefits for domestic fossil fuel production. The proposals and their revenue gains between 2010 and 2020 include:

- Repeal percentage depletion for oil and natural gas wells and hard mineral fossil fuels ($11.3 billion)
- Repeal expensing of intangible drilling costs for oil and gas and expensing of exploration and development costs for coal ($8.3 billion)
- Increase amortization period for geological and geophysical amortization period for independent producers to seven years ($1.1 billion)
- Repeal capital gains treatment for coal royalties ($0.8 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); and
- 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 Administration 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 $17.3 billion over 10 years; repealing the deduction for coal and other hard mineral fossil fuels would raise another $0.1 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 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.

Tax Carried Interest as Ordinary Income

The president proposes to tax the income from so called carried interest as ordinary income rather than as capital gains as under current law. Ordinary income is subject to marginal rates up to 35% (39.6% after 2010) while income from capital gains is taxed at a maximum rate of 15% (20% after 2010).

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 this as ordinary income on the grounds that, for the manager, it 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 general rules for taxing partnerships in which the characteristics of a firm'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 tax-free compensation for services. The carried interest represents therefore a form of deferred compensation instead of a share in the partnership's capital gain.

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, thereby treating the manager the same as others who are compensated with shares or other investment interests. However, the IRS has been reluctant to tax a "pure profits" interest (that is the partner has no interest in existing partnership assets at the time the interest is acquired) because of the difficulty of valuing the interest.

Under the president's proposal, a partner's share of income from a "services partnership interest" (SPI) 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 SPI. If a partner sells an SPI, the gain would be taxed as ordinary income, not as a capital gain.

Income that a partner earns from capital invested in the partnership would not be taxed as a capital gain provided that the partnership reasonable allocates income across invested capital and carried interest.

Additional Resources

Tax Policy Briefing Book: Business Taxation: What is carried interest and how should it be taxed? http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm

Tax Policy Briefing Book: Business Taxation: What are the options for reforming the taxation of carried interest? http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest-reform.cfm

Discussion of alternative approaches:

Victor Fleisher, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds." *New York University Law Review* 2008. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440

Michael Schler, "Taxing Partnership Profits as Compensation Income," *Tax Notes*, Vol. 119(8), May 28, 2008. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1136504

Reform U.S. International Tax System

The president proposes to tighten enforcement of tax laws to limit offshore tax evasion and change the way U.S. businesses are taxed on foreign income. In combination, the proposals would raise $122 billion over the 2010-2020 period.

During his campaign, the president promised to make it more difficult for individuals to use foreign tax havens to evade U.S. taxes. The budget would make good on this promise with a collection of measures designed to combat tax evasion by Americans and foreigners who use offshore accounts to shelter income from U.S. taxation. Those provisions, which would raise $5.4 billion from 2010 to 2020, would require more information reporting, increase tax withholding, and strengthen penalties to support U.S. taxation of income earned or held in offshore accounts or entities.

The president also proposes to change the way the international income of American corporations is taxed. Currently, the U.S. taxes both the domestic and foreign earnings of U.S. corporations. The time at which firms pay U.S. taxes on their foreign profits depends on how the parent company organizes its foreign operations. If operations are organized as subsidiaries (that is, they are separately incorporated in the foreign country), then the profits are *generally* not taxed until they are paid to the U.S. parent. If operations are organized as branches (that is, they are not separately incorporated in the foreign country), then the profits are taxed when they are earned.

Not all classes of foreign source income earned by foreign subsidiaries enjoy deferral. Under 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. 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 U.S. 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 offset the $10 net U.S. tax liability on the first subsidiary (in the low-tax country) against the $10 of excess credits of the second subsidiary (in the high-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 transferred 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 those countries, thus reducing their tax. To deal with this practice, for tax reporting purposes most governments require firms to use an "arm’s length" standard, 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, including 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 across 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 three provisions would take effect in 2011.

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 would receive no foreign tax credits for foreign taxes paid on deferred income until they repatriate that income. The provision would limit firms’ ability to blend their repatriations to minimize or avoid U.S. taxes on foreign source income. This proposal would also increase the cost of deferral.

The budget also includes a provision aimed at curbing methods companies use to inappropriately separate creditable foreign taxes from the associated foreign income. Under current law, companies can use a tax planning technique separate foreign tax credits from the underlying income. This allows them to claim credits for foreign taxes paid on income that has not been recognized for U.S. tax purposes. The president proposes to allow a credit for foreign tax only when and to the extent the associated foreign income is subject to U.S. tax in the hands of the taxpayer claiming the credit.

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. The inclusion of this proposal in the President's budget suggests that the Administration does not believe that the current transfer pricing regulations are working adequately for intangible property transfers. A second proposal would clarify the definition of intangible property in an effort to reduce controversy that has arisen in IRS examination. 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 the second provision would allow the Commissioner value multiple intangible properties on an aggregate basis if doing so would achieve a more reliable result.

In his State of the Union address, President Obama announced that "to encourage these [clean energy businesses] and other businesses to stay within our borders, it is time to finally slash the tax breaks for our companies that ship our jobs overseas, and give those tax breaks to companies that create jobs right here in the United States of America." The proposals have the effect of limiting the benefits of deferral and limiting income shifting, but would not create more jobs in the United States. The number of jobs in the United States has little to do with tax provisions that affect selected investments or industries. Instead, employment is influenced by fiscal and monetary policies—as well as periodic shocks to the system such as financial market meltdowns—that determine whether American and foreign consumers and investors are willing to purchase enough American-made goods, services, and assets to keep U.S. workers fully employed. Taxes can indirectly affect employment to the extent they affect overall wage levels, but the effect is likely quite small because labor supply is not very sensitive to wages. Specific tax incentives do affect where Americans work and what they produce. They also affect overall living standards by influencing how efficiently we use our scarce workers and capital and how much we invest for the future. Specific tax incentives have little impact on total employment.

Additional Resources

Tax Policy Briefing Book: International Taxation: How does the current system of international taxation work?
http://www.taxpolicycenter.org/briefing-book/key-elements/international/international-work.cfm

Eric Toder, "Will Paring Deferral Create Jobs?" *TaxVox*, May 5, 2009
http://taxvox.taxpolicycenter.org/blog/_archives/2009/5/5/4175662.html

Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Location," *National Tax Journal*, Volume LVI, No.2, Part 2. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=426380

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), Joint Committee on Taxation, September 2009. http://www.taxpolicycenter.org/taxtopics/budget/upload/jcs-4-09.pdf

Combat Under-Reporting of Income on Accounts and Entities in Offshore Jurisdictions

In recent years, members of Congress, many commentators, and the IRS have expressed growing concerns about Americans evading U.S. taxes by hiding assets in foreign bank accounts. U.S. citizens and residents with foreign accounts have long been required to file annual reports with the Treasury on these accounts (the notorious FBAR), and the IRS has recently redoubled its efforts to enforce this requirement. The U.S. government's efforts to obtain information about U.S. clients of the Swiss bank, UBS, have often been in the news, as have the criminal prosecution and imprisonment of a former UBS employee who supplied the government with some of its initial leads in the case. During 2009, the IRS offered a limited amnesty to taxpayers voluntarily disclosing offshore accounts. Probably because of the publicity given to the FBAR requirement and the USB case, the amnesty offer was reportedly accepted by hundreds of taxpayers.

The president proposes to strengthen and add to the IRS's tools for combating offshore evasion. According to the Treasury's Green Book, "For too long, some Americans have evaded their taxpaying responsibilities by hiding unreported income in a foreign bank account, trust, or corporation." These proposals are intended to "reduce such evasion." All of them are amendments to existing procedural rules, intended to strengthen the IRS's ability to uncover information about offshore accounts of American taxpayers. None of the proposals is self-executing. They will advance the goal of reducing tax evasion only if backed up with substantial investments of IRS resources, but with adequate effort from the IRS, the proposals could make a significant contribution toward the goal.

Qualified intermediaries. Since 2000, the IRS has had a program of making agreements with foreign financial institutions, mostly banks, that agree to serve as "qualified intermediaries" (QIs). A QI agrees to collect, process, and document information from its customers on U.S. source income that it receives for the customers. The principal documentation is an IRS prescribed "withholding certificate," by which the customer certifies whether he or she is a U.S. citizen or resident and, if not, whether the customer qualifies for reduced U.S. withholding tax. The benefit for a foreign financial institution is that a QI agreement allows the institution to determine the correct amounts of U.S. withholding taxes, thereby relieving its customers of the burden of filing for refunds of excess withholding taxes. For example, dividends paid by U.S. companies to foreign investors are subject to a withholding tax at a statutory rate of 30 percent, but if the investor resides in a country with a tax treaty with the United States, the tax is reduced to 15 percent. To get the 15 percent rate, the investor must either establish treaty residence in advance or file for a refund from the IRS after the fact. By making a U.S. investment through a QI, a foreign investor can, for example, establish entitlement to withholding at treaty rates without revealing information about himself or herself to U.S. tax authorities or any other person within the United States. A major benefit of the QI program for the IRS is that a QI must identify American investors receiving U.S. source income through the QI.

The president proposes several significant changes to the QI program. First, to increase pressure on foreign financial institutions (FFIs) to become QIs, the proposals would require an American financial institution or other U.S. firm to withhold a 30-percent tax from any payment it makes to an FFI other than a QI of (1) U.S. source dividends, interest, rents, or royalties or (2) gross proceeds from sales of stock or debt instruments of U.S. companies. If an FFI becomes a QI, in contrast, it has two options. It can undertake all U.S. withholding obligations for its clients, thus allowing it to receive payments from American institutions and firms free of all withholding. Alternatively it can assume a documentation role, in which case American institutions and firms will withhold from payments to the FFI to satisfy the actual U.S. tax obligations of the FFI's clients, as determined by the FFI. Because foreign investors in U.S. securities are generally not subject to U.S. capital gains taxes, no U.S. tax is withheld from sales proceeds received by a QI for a foreign client. The U.S. tax on a foreign investor's dividend or interest income is often less than 30 percent, and withholding on such income of foreign clients of a QI is at the actual rate, not the flat 30 percent.

Currently, a QI is only obligated to collect information on U.S.-source investment income of its customers, even for customers who are U.S. citizens or residents. The proposal would require a QI to identify accounts of U.S. citizens, residents, and companies, regardless of where the accounts are invested. A QI would also have to identify accounts of any foreign entity in which a U.S. citizen, resident, or company owns more than a 10 percent interest. A QI could satisfy these requirements by either providing detailed information about the accounts or filing Forms 1099 reporting income and sales proceeds credited to the accounts on a worldwide basis. A QI choosing the latter alternative would essentially function like a U.S. bank with respect to its U.S. customers. These reporting obligations would apply to accounts with other members of a QI's "expanded affiliated group," as well as accounts with the QI itself. An FFI thus could not avoid reporting on accounts of U.S. customers isolating the accounts in an entity separate from the entity that handles U.S. investments of non-U.S. customers and has a QI agreement with the IRS.

These proposals could potentially provide potent weapons in the IRS's war on offshore tax evasion. By adding to the IRS's ability to gather information on accounts with full-service FFIs, the proposals would encourage Americans determined to hide assets from the tax collector to use foreign financial intermediaries that do not serve non-U.S. clients investing in the United States and thus have no incentive to become QIs. The proposals would not, for example, affect a foreign firm organized to make non-U.S. investments for U.S. clients. At a minimum, however, the proposals would discourage offshore tax evasion by making it more expensive.

Because they would add significant administrative burdens for both current and new QIs, as well as the IRS, the proposals will likely encounter substantial opposition from the financial community. Because of these burdens, the proposals would not become effective until 2013.

U.S. income received through foreign intermediaries other than financial institutions. The president further proposes to require U.S. financial institutions and companies to withhold a 30-percent tax from U.S. source dividends, interest, rents, or royalties or proceeds of sales of stock or debt instruments of U.S. companies paid to foreign entities other than financial institutions. This withholding tax would not apply—and the usual withholding rules would apply—if (1) the entity either certifies that no U.S. citizen, resident, or company owns more than 10 percent of the entity or provides the name, address, and taxpayer identification number of each U.S. citizen owning such an interest and (2) the person making the payment does not know or have reason to know that any of certified information is incorrect. The proposal, effective for payments made after 2012, would complement the proposals on payments to foreign financial institutions described above. It would, for example, apply to a foreign trust created by a U.S. citizen to invest in the United States. Unlike the QI rules, it would not require reporting by a foreign entity because the U.S. government has no power to enforce a reporting requirement in this context. Because of this limitation, the proposal would do nothing to curb evasion by Americans hiding foreign assets in foreign entities.

Foreign-targeted bearer bonds. The United States has long imposed several tax penalties on issuers and holder of bearer bonds (bonds with respect to which the issuer does not maintain a registry of recognized owners). For example, an issuer is allowed no deduction for interest on bearer bonds and must pay an annual excise tax of one percent of the principal amount for each year in the bonds' term, and for foreign holders, the exemption of "portfolio interest" from U.S. withholding taxes does not apply to interest on the bonds. Congress adopted these penalties because bearer bonds are incompatible with the information reporting system on which the United States relies to enforce taxation of investment income. Under current law, the tax penalties do not apply to a bearer bond if interest on the obligation is payable only outside the United States and the written evidence of the obligation bears a legend stating that a U.S. citizen holding the obligation is "subject to limitations under the United States income tax laws." Congress provided this exemption to allow U.S. companies to issue bearer bonds in foreign markets to foreign investors, to whom the U.S. information reporting system does not apply. Over the years, as capital markets have become more globalized, it has become easier for U.S. taxpayers to acquire these foreign-targeted bearer bonds and use them to evade U.S. taxes with little fear of detection. The president proposes to eliminate the exemption, effective for obligations issued more than two years after the repeal is enacted into law. The proposal would probably make a small contribution to the war against offshore tax evasion.

Tax return disclosure of foreign accounts. Under current law, a U.S. citizen or resident must indicate on his or her tax return whether he or she has an interest in a foreign bank account, and if the person has foreign accounts with an aggregate balance of at least $10,000 at any time during the year, he or she must also file with the Treasury a separate Report of Foreign Bank and Financial Accounts, commonly known as the FBAR. A large penalty attaches to a failure to file the FBAR, but there is no specific penalty for failing to check the box on the tax return indicating ownership of a foreign account.

The president proposes to require individuals to disclose more information about foreign accounts on their tax returns and to add a penalty targeted at failure to make the tax return disclosure. The proposal would require a U.S. citizen or resident to include an information return with his or her tax return if (1) he or she has an interest in a foreign financial account or entity or holds as an investment a financial instrument or contract issued by a foreign person and (2) the aggregate value of all such items exceeds $50,000. The information return would require disclosure of detailed information about the interests, instruments, or contracts. The penalty for failing to file an accurate and complete return would be $10,000, the same as the penalty for failing to file the FBAR, but the IRS would be required to waive the penalty for an individual showing reasonable cause for a failure.

This proposal seems intended primarily to eliminate an awkwardness about the FBAR. Although the IRS administers the FBAR program, the FBAR is required by a statute outside the Internal Revenue Code and is filed separately from tax returns. As a consequence, a taxpayer's FBAR filings may not be readily accessible to tax auditors, and the IRS cannot use tax collection procedures to collect the FBAR penalty. The purpose of the proposal is to put foreign account disclosures more squarely into the tax assessment and collection process.

Accuracy-related penalty on underpayments attributable to undisclosed foreign financial assets. Current law imposes an accuracy-related penalty on a taxpayer whose return underreports tax liability if the underpayment is, for example, a substantial understatement of tax (as defined). The penalty, usually 20 percent of the underpayment, is generally imposed without regard to fault, but a taxpayer can escape the penalty by showing reasonable cause for an underpayment. Although the existing penalty can apply to an underpayment resulting from not reporting income from foreign bank accounts, the president proposes to expand the penalty to cover any understatement attributable to undisclosed foreign financial assets and double the penalty rate to 40 percent for such an understatement. The bite of this proposal lies mostly in the doubling of the penalty.

Extended statute of limitations for omissions of income from foreign financial assets. The IRS generally has three years after a taxpayer files a return to assess a deficiency in tax. This period is extended to six years if a taxpayer omits more than 25 percent of his or her gross income, and no statute of limitations applies to a taxpayer filing a fraudulent return. The president proposes a new six-year statute of limitation for a tax deficiency resulting from a taxpayer's omission of more than $5,000 of gross income from foreign financial assets that the taxpayer failed to disclose as required under a proposal described above or that the taxpayer would be required to disclose but for the $50,000 threshold on the disclosure obligation. Also, if the taxpayer fails to include the disclosure with his or her return, the limitations period would not begin to run until the disclosure is filed.

Reporting of transfers to or from foreign financial accounts. The current FBAR requirements and the proposed tax return disclosures described above are annual reports on interests in foreign financial accounts. The president proposes to add a requirement to disclose transfers to and from those accounts. The proposal would generally require a U.S. citizen or resident to include with his or her income tax return a disclosure of all transfers of money or property that he or she made during the year to foreign bank, brokerage, or other financial accounts and any receipt of money or property from such an account. If a U.S. citizen or resident owns more than 25 percent of an entity that made or received such a transfer, the entity would be required to disclose the transfer. These requirements would only apply for a particular year if either the cumulative amount or value of transfers made or the cumulative amount or value of receipts was at least $50,000. An individual failing to comply with the requirements would generally be liable for a penalty of $10,000 for each unreported transfer or, if less, 10 percent of the cumulative amount or value of the unreported transfers, but the penalty would be waived for an individual showing reasonable cause for all failures.

The proposal would require a U.S. financial institution to report any such transfer that it makes or receives on behalf of a U.S. citizen or resident if the aggregate of the transfers made or received in the individual's behalf exceed $50,000 during a calendar year. A U.S. financial institution would also have to make this report if it made or received transfers exceeding $50,000 on behalf of an entity if a U.S. individual owns more than 25 percent of the entity. A U.S. financial institution would have to report opening a foreign bank, brokerage, or other financial account on behalf of a U.S. individual or such an entity.

These proposals would apply to transfers made after 2012.

Proposals affecting foreign trusts and their grantors, beneficiaries, and trustees. Under current law, a U.S. citizen transferring property to a foreign trust (a U.S. grantor) is treated as owner of the trust, and is hence taxed currently on its income, if at least one of the trust's beneficiaries is a U.S. citizen or resident. The president proposes an amendment under which a trust that has received property from a U.S. grantor would be deemed to have a U.S. beneficiary for a taxable year unless the grantor demonstrates in an annual information return that no U.S. citizen could benefit from the trust during the year.

Under current law, a foreign trust’s loan of cash or marketable securities to a U.S. grantor or beneficiary of the trust is treated as a distribution to the grantor or beneficiary. The proposals would extend this rule to apply to a grantor’s or beneficiary’s use of trust assets other than cash or marketable securities.

Current law requires the filing of information returns on foreign trusts. The penalty for failing to file these returns is generally 35 percent of the reportable amounts, but the IRS often discovers the existence of foreign trusts from sources containing no information about the assets and income of the trusts. The proposals would restate the penalty as the greater of $10,000 or 35 percent of the reportable amounts, with the understanding that the IRS would impose the $10,000 amount when it is unable to ascertain the reportable amounts.

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 receives funding from two annual appropriations: 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 (on petroleum, chemical feedstocks, and imported substances using hazardous chemicals subject to 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.

When they expired at the end of 1995, Superfund taxes included 1) an excise tax of 9.7 cents per barrel on crude oil or refined oil products; 2) excise taxes of $0.22 to $4.87 per ton on certain hazardous chemicals; 3) 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 4) 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 the three Superfund excise taxes and the corporate environmental income tax as of January 1, 2011. Under the president's proposal, these taxes would sunset after December 31, 2020.

Proponents of reinstating the Superfund taxes argue that imposing these taxes is consistent with a "polluters pay" principle: industries and companies that used hazardous substances should bear the cleanup costs. But, in all likelihood, the taxes are passed forward to consumers. Further, the pollution in question is legacy contamination, so the incidence is unlikely to reach culpable parties. Proponents also argue that the Superfund taxes may discourage the use of toxins and, ultimately, hazardous waste. However, 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 waste ("waste end" taxes) would be more efficient. The corporate income tax component of the Superfund taxes is extremely complex. Firms had to compute a corporate AMT liability even if they did not pay the tax.

Additional Resources

Congressional Research Service Report on Superfund Taxes (CRS Report RL31410)
http://www.cnie.org/NLE/CRSreports/08Mar/RL31410.pdf

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 first-in-first-out (FIFO) 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 last-in-first-out (LIFO) as long as they use the same method for financial statement purposes. This method assumes that the 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, which both reduces current income and assigns a lower value to the year-end inventory.

The Obama budget would repeal 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. This one time increase in gross income would be taken into account ratably over the subsequent ten years beginning after December 31, 2011.

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 its inventory would impose a substantial one time tax and a smaller permanent annual tax as long as prices are increasing.

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 (IFRS). 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.

Additional Resources

Discussions of LIFO repeal:

Edward D. Kleinbard, George A. Plesko and Corey M. Goodman, "Is It Time to Liquidate LIFO?" *Tax Notes*, Vol. 113 (3), October 10, 2006. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941201

Alan D. Viard, "Why LIFO repeal is Not the Way to Go" *Tax Notes*, Vol. 113, November 6, 2006. http://www.aei.org/publications/filter.all,pubID.25111/pub_detail.asp

Reform Treatment of Insurance Companies and Products

The budget contains four proposals that would change the tax treatment of insurance companies and their products. We evaluate three of them here.

Expand Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance (COLI). An insurance company will credit interest on life insurance policies, which generally increases the policies' cash surrender value. This interest is not currently taxable. If a company could borrow to purchase such a policy and deduct the interest, they would be matching currently deductible interest against deferred 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, 2010. 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 Special Accounts. Corporations may deduct from 70 percent to 100 percent of dividends received from other corporations in order to avoid taxing that income twice at the corporate level. The dividend has already been taxed to the distributing corporation and the deduction avoids a second full corporate tax levied on the recipient. 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 would limit the share of the dividend to which the deduction applies to no more than the company's economic interest in the dividend.

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. 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, 2010.

Continue certain expiring provisions through CY 2011

The revenue code includes more than 80 "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 (AMT, 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). Others encourage a broad range of investment from alternative energy to low-income housing.

The Administration baseline includes permanent extension of AMT relief. The 2009 AMT parameters—exemptions, rate brackets, and phaseout thresholds—are made permanent and indexed for inflation at a ten year cost of $659 billion. The president proposes making the research credit permanent at a cost of $83 billion over 10 years and extending a number of other expiring provisions for an additional year through 2011 with a one-year cost of more than $33 billion. These provisions include the optional deduction for state and local general sales taxes; the Subpart F "active financing" and "look-through" exceptions; the exclusion from unrelated business income of certain payments to controlling exempt organizations; the modified recovery period for qualified leasehold improvements and qualified restaurant property; incentives for empowerment and community renewal zones; and several trade agreements, including the Generalized System of Preferences and the Caribbean Basin Initiative. Keeping with his promise to phase out subsidies for fossil fuels made at the G-20 Summit in Pittsburgh, the president would allow incentives for the production of fossil fuels to expire as scheduled under current law.

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 this review process has become a sham. Meanwhile, many beneficiaries act as if the provisions are permanent but congressional delay in reenacting them in a timely manner can lead to uncertainty and cause concern.

Additional Resources

Tax Policy Briefing Book: Taxes and the Budget: What are extenders?
http://www.taxpolicycenter.org/briefing-book/background/taxes-budget/extenders.cfm

Joint Committee on Taxation Revenue Estimate of Extenders
http://www.jct.gov/publications.html?func=startdown&id=3639

Joint Committee on Taxation List of Expiring Federal Tax Provisions 2009-2020
http://www.jct.gov/publications.html?func=startdown&id=3646

Tax Extenders and Fiscal Responsibility (a discussion of pros and cons of extenders)
http://taxvox.taxpolicycenter.org/blog/_archives/2008/5/29/3718936.html

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.

CDEs are certified by a branch of the Treasury, the Community Development Financial Institutions Fund (CDFI), and participate in a competitive process for the right to receive tax-preferred financing. A qualified CDE is an 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, CDFI has 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.[§§§§] The NMTC expired at the end of 2009.

The president's 2011 budget proposes to extend the NMTC for two additional years at a cost of $3.4 billion over 11 years. The extension would allow for the higher allocation amounts implemented under ARRA—$5 billion per year—and continue the practice of allowing the NMTC to be deductible against the AMT.

Additional Resources

GAO: 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

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

Tax Revenue Adjustments to Baseline

Rather than assume a baseline that projects future revenues that would accrue under current tax law, the budget assumes a baseline that permanently indexes the alternative minimum tax (AMT) for inflation, extends the 2001 and 2003 income tax cuts beyond their scheduled sunset in 2011, permanently extends the estate tax with 2009 parameters, and makes permanent provisions reducing the marriage penalty for the earned income tax credit (EITC) and expanding refundability of the child tax credit (CTC).[*] Those assumptions reduce tax revenues by more than $3.8 trillion over the next decade. Given that baseline, proposals that would reinstate portions of pre-2001 tax law show up as revenue raisers, even though they would occur as a matter of course if Congress did not act to prevent them.

Index 2009 parameters of the AMT to inflation

Since 2001, Congress has repeatedly increased the individual alternative minimum tax (AMT) exemption on a temporary basis to prevent too many taxpayers from being subject to the tax. The temporary legislation has also allowed taxpayers subject to the AMT to use personal nonrefundable tax credits, including credits for childcare and higher education, which the AMT normally disallows. Absent these stopgap measures, sometimes called "the patch," the AMT exemption would stay at the nominal levels established in 1993, and the AMT would affect almost a third of all taxpayers.

The stimulus bill (“American Recovery and Reinvestment Act of 2009”) extended the patch through 2009, setting the exemption level at $46,700 for single and head of household filers, $70,950 for married people filing jointly and qualifying widows or widowers, and $35,475 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 $112,500 and $299,300 for singles and heads of household, between $150,000 and $433,800 for married couples filing jointly, and between $75,000 and $216,900 for married couples filing separately. The phaseout creates *effective* AMT tax rates of 32.5 percent—125 percent of 26 percent—and 35 percent—125 percent of 28 percent for affected taxpayers.

The president proposes to make permanent the 2009 AMT parameters—exemptions, rate brackets, and phaseout thresholds—and index them for inflation. That 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 of the benefits of the change would go to taxpayers with relatively high incomes: about three-fourths of the tax cut in 2012 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 over $1,800, raising their after-tax income by more than 0.9 percent.

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[*] See earlier discussion of the proposals included in the administration's baseline regarding the EITC (page 13) and the child tax credit (page 14).

Distribution tables

Index 2009 parameters of the AMT to inflation

2012 versus current law by cash income

2012 versus current law by cash income percentiles

Additional Resources

Tax Topics: Individual Alternative Minimum Tax (AMT)
http://www.taxpolicycenter.org/taxtopics/AMT.cfm

Stimulus Act Report Card: Extend the Alternative Minimum Tax Patch through 2009
http://www.taxpolicycenter.org/taxtopics/conference_AMT.cfm

Tax Policy Briefing Book: Key Elements of the U.S. Tax System: Alternative Minimum Tax
http://www.taxpolicycenter.org/briefing-book/key-elements/amt/index.cfm

Make 2009 estate tax permanent

In 2001, Congress voted to phase out the estate tax gradually and repeal it entirely in 2010. However, unless the law is changed, starting in 2011 estates valued at $1 million or more would again be subject to tax at progressive rates as high as 60 percent. This extraordinary situation places great pressure on Congress and the President to reconsider the tax this year.

The Obama budget assumes permanent extension of the estate tax under 2009 parameters as part of its baseline. Estates with a net value over $3.5 million or more would face a 45 percent tax rate. For married couples, a modest amount of tax planning would raise the exemption to $7 million. Making permanent the 2009 estate tax provisions would reduce federal revenues by $234 billion over the coming decade. However, because the administration proposes to build the extension into the budget baseline, the budget itself shows no revenue cost from this proposed change.

Distribution tables

Make 2009 estate tax permanent

- 2012 versus current law by cash income
- 2012 versus current law by cash income percentiles
- 2012 versus current law plus repeal of estate tax by cash income
- 2012 versus current law plus repeal of estate tax by cash income percentiles

Additional Resources

Tax Topics: Estate and Gift Taxes http://www.taxpolicycenter.org/taxtopics/estatetax.cfm

Tax Policy Briefing Book: Key Elements of the U.S. Tax System: Wealth Transfer Taxes http://www.taxpolicycenter.org/briefing-book/key-elements/estate/index.cfm

Continue the 2001 and 2003 tax cuts

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 limitations on itemized deductions and the phaseout of personal exemptions. All of those changes are scheduled to sunset in 2011, when the individual income tax will revert to its pre-2001 levels. The president includes permanent extension of the tax cuts beyond 2010 as part of his budget baseline. As a result, proposals that would impose pre-2001 tax rates on high-income taxpayers show up as tax increases, even though they would simply impose the same taxes on those taxpayers as would occur under current law.

The following table compares various aspects of the income tax in 2011 under current law and assuming that permanent extension of the 2001 and 2003 tax cuts.

Income Tax Provisions		Current Law in 2011	2011 Assuming Extension of 2001 and 2003 Tax Cuts
Tax Rates (2011 income ranges for single filers)	$0 - $8,500	15%	10%
	$8,500 - $34,550	15%	15%
	$34,550 - $83,700	28%	25%
	$83,700 - $174,600	31%	28%
	$174,650 - $379,650	36%	33%
	$379,650 and over	39.6%	35%
Standard deduction and 15% tax bracket for joint filers		167% of single filers	200% of single filers
Child Tax Credit		$500	$1,000
Child and dependent care credit	Max. creditable amount	$2,400/child, max $4,800	$3,000/child, max $6,000
	Credit rate	20% - 30%	20% - 35%
Phaseout of Personal Exemption		Over $122,500 range	No phaseout
Limitation of Itemized Deductions		Up to 80%	No Limitation
Tax on long-term capital gains	15% bracket of lower	10%	0%
	above 15% bracket	20%	15%
Qualified Dividends	15% bracket of lower	Regular tax rate	0%
	above 15% bracket	Regular tax rate	15%

Distribution tables

Continue the 2001 and 2003 tax cuts

2012 versus current law by cash income

2012 versus current law by cash income percentiles

Additional Resources

Distribution of the 2001-2006 Tax Cuts: Updated Projections, July 2008

http://www.taxpolicycenter.org/publications/url.cfm?ID=411739

Tax Topics: Distribution of the 2001 - 2006 Tax Cuts

http://www.taxpolicycenter.org/taxtopics/cuts0106.cfm

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 2011 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. Only one individual income tax proposal—the increased refundability of the child credit—would lack indexing.[*****] The earnings level at which refundability 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. By 2017, the threshold would drop to $2,653 in 2009 dollars.

The lack of complete indexation means that the real effect of the president's tax proposals would change over time. In 2017, 78 percent of all taxpayers would get tax cuts—relative to current law—down from 80 percent in 2012. Measured against the administration's preferred baseline, the percentage of taxpayers who would see their taxes go down would fall from 34 percent in 2012 to 31 percent in 2017.

[*****] Technically the budget also would not index the one-year extension of the Making Work Pay credit since it would extend the credit at the same nominal level used in 2009 and 2010. Because that provision would not become permanent, however, lack of indexation is less important.