Tax Policy Center
Urban Institute and Brookings Institution

TAX POLICY: FACTS AND FIGURES

October 2006

The early years of the 21st century have been marked by a major tax bill almost every year. This fact sheet looks at the impact of these laws on taxpayers, especially on who benefits and who doesn't, and discusses some unfinished business, including the future of the estate tax and the individual alternative minimum tax.

Much of the research cited in this fact sheet originated at the Urban-Brookings Tax Policy Center (www.taxpolicycenter.org).[1]

Distribution of the 2001-04 Tax Cuts

In May 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), sweeping legislation that reduced individual income tax rates; gradually reduced and eliminated the estate tax; doubled the child tax credit and made it partially refundable; reduced marriage penalties (and increased marriage bonuses); enhanced the child and dependent care credit; increased contribution limits on tax-deferred retirement savings vehicles, such as IRAs and 401(k)s; expanded credits and deductions for education-related expenses; and temporarily increased the alternative minimum tax (AMT) exemption. To keep the official 10-year cost estimate of the legislation to $1.35 trillion, Congress phased in many provisions over several years and allowed the entire bill to "sunset," or expire, at the end of 2010.

Two years later, Congress passed the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which accelerated the individual tax rate reductions in EGTRRA that were not scheduled to take place until 2006. It also sped up other major provisions in EGTRRA, such as the increased child credit and some marriage-penalty relief provisions. In addition, the legislation reduced the tax rate through 2008 on most long-term capital gains and applied the capital gains rates to dividends, which had previously been treated as ordinary income. Again, to keep the official 10-year cost of the bill to $350 billion, the legislation sunsets by 2010.

The Working Families Tax Relief Act of 2004 (WFTRA) extended temporarily some of the provisions in EGTRRA and JGTRRA, such as the increased child credit, the new 10-percent bracket, some of the marriage-penalty relief provisions, and an increase in the AMT exemption. WFTRA accelerated an increase in the partial refundability of the child tax credit. The official 10-year cost of the bill is $146 billion.

- **The tax cuts are regressive.** In 2005, EGTRRA, JGTRRA, and WFTRA tax cuts averaged 2.6 percent of after-tax income ($742) for those in the middle quintile of the income distribution. Those in the top 1 percent received an average tax cut of 4.6 percent

[1] Estimates are derived using Version 0305 of the Urban-Brookings Tax Policy Center Microsimulation Model.

of after-tax income ($34,948). The top one-tenth of 1 percent—taxpayers with income greater than $1.75 million—received an average tax cut of 5.6 percent of after-tax income ($185,533).

- **The tax cuts will become even more regressive.** This occurs because some of the provisions that primarily benefit upper-income families—such as repeal of the estate tax—phase in gradually. If the tax cuts are made permanent and AMT relief is extended, then in 2011 the top one-tenth of 1 percent of income earners will receive an average tax cut of 7.5 percent of after-tax income ($307,135), and the top 1 percent will receive an average cut equal to 6.5 percent of after-tax income ($61,442). Those in the middle of the income distribution will receive an average cut of 2.3 percent ($836).
- **Making the tax cuts permanent will shift the burden of the federal tax system onto middle-income taxpayers.** In 2011, if the tax cuts are made permanent and there is an AMT fix (see the discussion on page 5), taxpayers in the top 1 percent of the income distribution would receive 28.2 percent of the total benefits although they pay only 24.7 percent of all federal taxes. As a result, their share of the overall federal tax burden would fall by 0.5 percentage points. By contrast, the share of the overall federal tax burden paid by households in the middle of the income spectrum would rise by 0.1 percentage points; they would receive only 7.7 percent of the tax cut benefits even though they pay 8.2 percent of all federal taxes.
- **Tax cuts do not represent a free lunch.** Virtually all economists agree that at some point, tax cuts must be paid for with either spending reductions or other tax increases. Assuming they are either financed with spending cuts or a combination of reduced spending and progressive tax increases, more than 70 percent of households will be net losers; only those in the top income quintile will, on average, benefit.

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Distribution of the 2006 Tax Cuts

In May 2006, Congress passed the Tax Increase Prevention Reconciliation Act of 2005 (TIPRA), which extended through the end of 2010 the reduced rates on capital gains and dividends originally enacted by JGTRRA; increased the AMT exemption level but only for 2006; eliminated the income limitation on converting traditional IRAs to Roth IRAs beginning in 2010, effectively doing away with the income cap for Roth IRA contributions; and extended the increased expensing allowance for businesses.

Later in 2006, Congress passed the Pension Protection Act of 2006 (PPA), the first legislation that makes some EGTRRA provisions permanent. These include elements affecting pensions, IRAs, and the saver's credit, which provides a government match for contributions by lower- and moderate-income taxpayers to tax-deferred savings vehicles.

- **TIPRA is highly regressive.** The top one-tenth of 1 percent of income earners will receive an average tax cut of $83,966, equivalent to 2.4 percent of after-tax income. Taxpayers in the middle of the income distribution will, on average, receive $20, or less than one-tenth of 1 percent of after-tax income.
- **TIPRA shifts the tax burden away from upper-income earners.** Taxpayers in the top fifth of the income distribution receive 93.6 percent of the benefits of this legislation although they pay only 72.1 percent of federal taxes. As a result, their share of the overall federal tax burden falls by 0.8 percentage points. Those in the middle of the income spectrum receive 0.9 percent of the benefits.
- **The Roth conversion provision in TIPRA is a stealth budget-buster.** The official Joint Committee on Taxation cost estimate shows the Roth conversion proposal generating a $6.4 billion revenue gain over the next 10 years. In fact, the provision begins losing revenue annually in 2014—in present value terms, the net loss in federal revenue through 2049 is more than $14 billion.
- **PPA is roughly distributionally neutral.** Because of the saver's credit provisions, lower- and moderate-income taxpayers receive about the same average increase in after-tax income as those in higher-income brackets, between 0.1 and 0.2 percent.

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Estate Tax

Under current law, the estate tax is reduced gradually through 2009—when the exempt amount reaches $3.5 million and the top rate is reduced to 45 percent—and is repealed in 2010. One year later, in 2011, the estate tax is reinstated with an exemption of $1 million and a top statutory rate of 55 percent.

- **The estate tax affects very few individuals.** In 2006, with an estate tax exemption of $2 million, an estimated 30,300 estate tax returns will be filed. Fewer than 13,000 of these will be taxable, with net estate tax liability of $18.3 billion. By 2009, with an exemption of $3.5 million, an estimated 17,500 returns will be filed. In that year, 7,200 taxable returns are projected to generate $16.3 billion in estate taxes.
- **The estate tax is highly progressive.** Almost all of it is paid by the highest-income 10 percent of tax units. The top 1 percent pays 90.3 percent of the tax, and 45.3 percent falls on the richest 1 in 1,000 (those with 2006 incomes of $1.5 million or more).
- **Very few farms and small businesses must pay the estate tax.** Much of the debate about the estate tax centers on its impact on farms and small businesses. Roughly 350 taxable estates—or 2.8 percent of all taxable estates—will be primarily made up of farm and business assets in 2006. Just over 200 will be small farms or businesses (valued at $5 million or less); these small enterprises will account for only 1 percent of total estate tax liability.
- **Recent legislation is almost as costly as full repeal.** Passed in August 2006, H.R. 5970 would gradually raise the exemption to $5 million by 2015—and index it to inflation thereafter—and lower the rate on estates under $25 million to the capital gains tax rate, currently 15 percent. The rate for the wealthiest estates would be phased down to 30 percent. If the lower rates on capital gains are extended, then over the next 10 years, this bill would result in a loss of estate tax revenue that is two-thirds as much as that of outright repeal. In 2015, the plan would lose 84 percent as much revenue as repeal and the average effective tax rate on estates would be only 8.2 percent, far lower than the statutory rates of 15 and 30 percent (assuming extension of the lower capital gains rates).

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Alternative Minimum Tax and Complexity

In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 taxpayers with incomes exceeding $200,000 had paid no federal individual income tax in 1966. In response to an ensuing firestorm of protest, Congress created a minimum tax to prevent the wealthy from taking advantage of tax laws to eliminate their federal income tax liability. The current individual alternative minimum tax (AMT) requires tax liability to be calculated twice: once under regular income tax rules and again under the AMT rules. If liability under the AMT is higher, taxpayers pay the difference as a surcharge to the regular income tax. The AMT rules differ from those in the regular income tax by disallowing certain deductions, exclusions, and credits and by limiting income-sheltering rules.

The original minimum tax and its successor, the AMT, have applied to a small minority of high-income households. But barring significant reform, this "class tax" will soon be a "mass tax."

- **The number of AMT taxpayers is set to skyrocket.** Under current law, about 31 million taxpayers will pay the AMT in 2010, almost nine times the 3.6 million affected in 2005. The AMT will raise over $112 billion in 2010, up from $20 billion in 2005. The AMT will become the de facto tax system for filers in the $200,000–$500,000 income range, 94 percent of whom will face the tax in 2010. But the increase in its coverage will occur in lower income classes as well. In 2005, for example, only 1 percent of tax filers with income between $75,000 and $100,000 faced the AMT; by 2010, 49 percent of them will pay the tax.
- **Because the AMT disallows certain deductions and credits, it hits some taxpayers harder than others.** The AMT does not allow deductions for state taxes, thereby imposing higher burdens on those who live in high-tax states. In 2005, taxpayers in these states were more than three times as likely to be on the AMT as those in low-tax states; by 2010, this difference falls to one-third. In addition, the AMT does not allow deductions for dependents and imposes significant marriage penalties. By 2010, 89 percent of married couples with two or more children and income between $75,000 and $100,000 will face the AMT, up from just 1.8 percent in 2005.
- **The dramatic AMT expansion occurs largely because the AMT is not indexed for inflation and because of the tax cuts enacted since 2001.** The 2001–04 tax cuts more than doubled the projected share of taxpayers who will face the AMT in 2010, from 14 percent to 31 percent. If the tax cuts had not been enacted and the AMT had been indexed for inflation along with the regular income tax in 1985, the number of AMT taxpayers would have remained between 300,000 and 400,000 through 2010, rather than rising to 31 million.
- **The AMT is mind-numbingly complex.** The Internal Revenue Service and its Taxpayer Advocate have flagged the AMT as one of the most complicated tax provisions to comply with and administer. Most people who must fill out the AMT forms end up owing no additional taxes. The AMT also creates complicated interactions with the regular income tax.
- **Recent laws have added more twists to the tax maze.** Besides doubling the size of the AMT problem, legislation enacted since 2001 added more than 100 tax breaks to an

already unwieldy tax system. Simplification was relegated in 2005 to the President's Advisory Panel on Federal Tax Reform, a widely ignored panel of experts.

- **The AMT will undo some of the benefits of the tax cuts.** By 2010, the AMT will "take back" about 29 percent of the overall income tax cut, including more than 71 percent of the cut going to taxpayers with income between $200,000 and $500,000.
- **Fixing the AMT would be extremely costly.** In May 2006, Congress passed a temporary increase in the AMT exemption that expires at the end of 2006. If the 2001–04 tax cuts are made permanent, extending this temporary relief and indexing the increased exemption for inflation would cost $848.3 billion over the next 10 years. Outright repeal would cost $1.27 trillion.

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Note on Income Breaks

Income groups cited in this fact sheet use cash income as the qualifier, except for data about the estate tax, which use economic income. More about these breaks can be found at http://taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm?DocID=1123.

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