Tax Policy

In This Chapter

EXECUTIVE SUMMARY

Our federal tax code is overly complicated and burdensome to families, businesses and individuals. Our country's total tax burden has risen to its highest historical levels, but it still is not producing enough revenue to meet its financial obligations. The federal government is currently spending far more than it collects in revenues and, if some current policies are continued, will do so for the foreseeable future.

The current tax system finds itself once again at a crossroads. Adding to the longstanding arguments over the structure of the tax code and budget deficits, there are "new" concerns regarding the unprecedented levels of spending courtesy of Congressional Democrats and President Obama in the previous 111th Congress – from the 2009 economic stimulus package to the government takeover of health care. The scheduled expiration of the 2001 and 2003 tax cuts at the end of 2012 is also of great concern.

For a large portion of our country's history, internal revenue taxes were not as important a source of federal government revenue as customs duties and other receipts, like the sale of public lands. Internal taxes did not become the largest source of federal revenue until 1865, and then only for three years. During the time period leading up to the Civil War, the federal government was very small and it operated almost without debt as well as without taxes (aside from customs duties, various excise taxes, etc.). The first income tax was levied in 1861 as a flat tax at three percent on annual income above $800 (equivalent to roughly $20,690 today). The Office of Commissioner of Internal Revenue was also created the following year. In 1953, the Eisenhower Administration changed its name to the Internal Revenue Service (IRS).

In general, there are at least eight categories of federal taxation: the individual income tax, the Alternative Minimum Tax (AMT), payroll taxes, business taxes, excise taxes, estate and gift taxes. Within the category of business taxes, there are roughly four types of businesses subject to federal business taxes and each are taxed in different ways. "S" corporations, partnerships and sole proprietorships are taxed under the individual income tax. "C" corporations, or publicly-held corporations, are subject to the corporate income tax as well as the individual income tax, the estate and gift tax, excise taxes and Social Security taxes.

The tax cuts enacted between 2001 and 2006 contain a host of large and small changes to the tax code that phase in at different rates and expire at different times. The tax cuts of 2001, 2003, 2004, 2005 and 2006 built on one another with many of the bills passed after 2001 serving to extend provisions in earlier bills. The combination of the 2001 and 2003 bills are what are most often referred to as the "Bush Tax Cuts," as these bills contained the most substantive changes to the tax code. Most provisions are now scheduled to expire at the end of 2012.

The 2001 and 2003 tax cut bills cut income tax rates, dividend tax rates and the capital gains tax, reduced the estate and gift taxes to zero in 2010, expanded the earned income tax credit, reduced the marriage penalty, expanded the child tax credit and allowed small businesses to deduct a more generous share of their expenses. Those are just the big ones.

The main intent of the tax code is to provide revenue for the federal government. The tax code is frequently, however, used to achieve social, economic and political goals. Because the government uses the tax code as an instrument of social policy, the code has grown in size and complexity while lacking a central organizing principle. Many proposals have been suggested regarding federal tax reform ranging from a broader-based, flat-rate income tax to a national sales tax to replace the current system, to more incremental changes or identifying additional revenue-raising options. Whatever the solution, most Members of Congress agree that significant reform of the current federal tax system is needed. Enacting any major reform, however, will require momentous bipartisan support as the current popular tax reform proposals all contain their share of significant political ramifications.

THE BASICS

The federal tax law is administered primarily by the Internal Revenue Service (IRS), a bureau of the United States Treasury Department. The tax code is known as the Internal Revenue Code (IRC). In the House of Representatives, the House Committee on Ways and Means has the responsibility for raising the revenue required to finance the federal government, which includes jurisdiction over federal tax policy, trade policy and the authority of the federal government to borrow money, among other responsibilities. Additionally, the Joint Committee on Taxation (JCT) is a nonpartisan committee of Congress, originally established under the Revenue Act of 1926. The JCT is closely involved in every aspect of the tax legislative process.

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"All Bills for raising Revenue shall originate in the House of Representatives."

~ Article I, Section VII, United States Constitution

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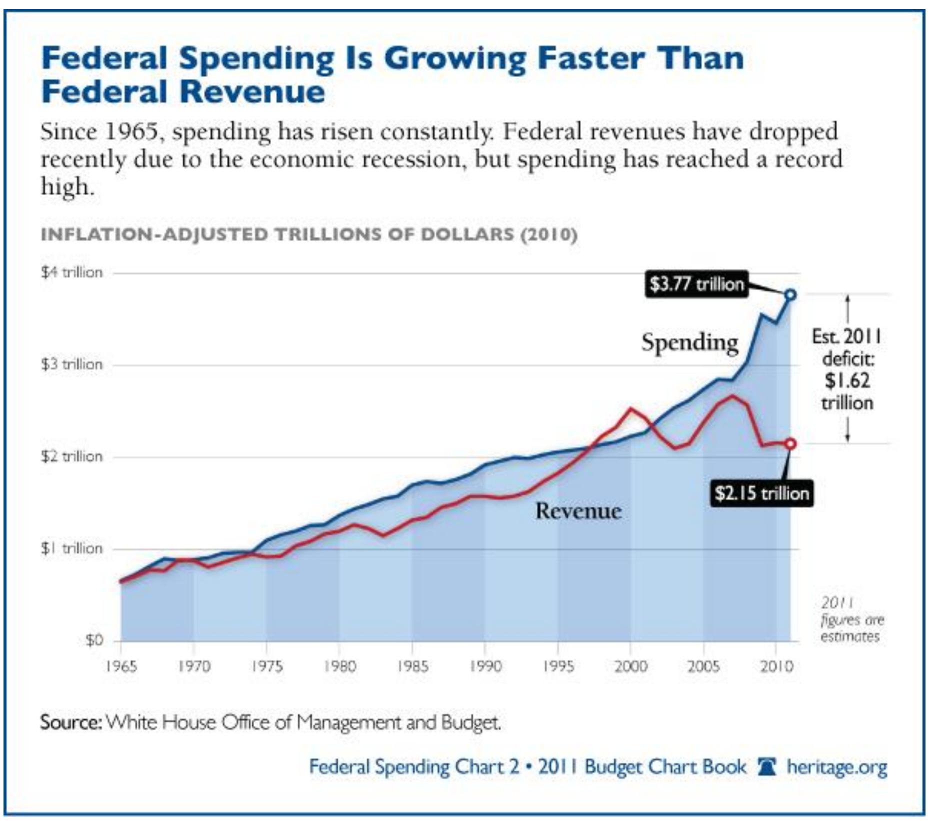
The federal tax system is composed of several sources of tax revenue: the individual income tax, Social Security and other payroll taxes, corporate income tax, excise taxes, estate and gift taxes, customs duties and other taxes. The individual income tax is the major source of federal revenues, followed closely by Social Security and other payroll taxes. As a revenue source, the corporate income tax is a distant third. Estate, gift and excise taxes play only minor roles as revenue sources.

Despite the fact that our Nation's total tax burden has risen to its highest historical levels, it still is not producing enough revenue to match our financial obligation. The federal government is currently spending far more than it collects in revenues and, if some current policies are continued, will do so for the foreseeable future. Over the long term, three major entitlement programs – Medicare, Medicaid and Social Security – account for the majority of growth in federal spending relative to revenues. "Stimulus" and other so-called "economic growth" legislation have also contributed to the imbalance. No reasonably foreseeable rate of economic growth would overcome the projected deficit. That leaves three choices to rein in future deficits: a large increase in taxes to support these programs, major restraints on their growth or some combination of the two.



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INTERNAL REVENUE TAXATION AND THE EVOLUTION OF THE IRS

For a large portion of our country's history, internal revenue taxes were not as important a source of federal government revenue as customs duties and other receipts, like the sale of public lands. Internal taxes did not become the largest source of federal revenue until 1865, and then only for three years. The income taxes imposed in 1861 were dropped after the Civil War and were not reinstated as revenue sources until 1909. They did not become the permanent largest source of federal revenue until 1914. During the time period leading up to the Civil War, the federal government was very small and it operated almost without debt as well as without taxes (aside from customs duties, various excise taxes, etc.). When deficits did occur, the resulting debt was paid off within a few years. But, beginning in 1861, taxes were imposed on product sales, on income, on inheritances and gifts and on property (apportioned among the states according to population). Internal revenue taxation by the federal government has been a feature of American life ever since.

The first income tax was levied as a flat tax at three percent on annual income above $800 (equivalent to roughly $20,690 today). No provision was made at the time of enactment in 1861 for collection and nothing was ever collected. Therefore, the following year, the Revenue Act of 1862 not only replaced this tax with a graduated tax of three to five percent on income above $600, it also created the Office of Commissioner of Internal Revenue within the Treasury Department to collect new taxes. It also authorized the president to divide the country up into "convenient collection districts" and to appoint for each a tax assessor and a tax collector. Following the end of the Civil War, many taxpayers complained that the government's tax collection efforts were altogether too successful. But, Congress thought the efforts were inadequate and created a three-person "revenue commission" to study the tax system and recommend improvements. Per this commission's recommendations, in 1866 the Office of Commissioner of Internal Revenue was reorganized and its staff was expanded.

Following this expansion of the Office of Internal Revenue, the progressive income tax rates of the Civil War were reduced to a flat rate in 1867; income taxes were reduced and inheritance taxes were repealed in 1870; and, finally, the income tax itself was completely done away with in 1872. For most of the rest of the 19th Century, the Office of Internal Revenue collected excise taxes mostly on alcohol and tobacco. During this time, there was also an experiment of sorts in the "privatization" of tax collections. In 1872, the Treasury Secretary was authorized to contract with private collectors to collect delinquent taxes. This was done away with by 1874 after the House Ways and Means Committee investigated and found that most of the taxes these private collectors had collected would have been collected by Internal Revenue collectors anyway.

The late 19th Century also began the use of the Office of Internal Revenue in the position of becoming the enforcer of essentially non-tax laws – a use that has grown over the years even into present day. In the 1890s, Internal Revenue was charged with collecting a regulatory tax on opium, with paying bounties to sugar producers and with registering Chinese immigrants.

The income tax that had been abandoned and declared unconstitutional in 1894 was revived, and ruled constitutional, for

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"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

~ Sixteenth Amendment, United States Constitution

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corporations in 1909. To avoid further questions of constitutionality, a constitutional amendment was also sent to the states in 1909 that would allow taxes on incomes. After ratification of the 16th Amendment in 1913, a new income tax covering both individuals and corporations was included in the Tariff Act of 1913.

The onset of World War II involved government spending unheard of even by comparison to earlier wars. Although most of it was financed by borrowing, it also involved truly massive tax increases. All sources of revenue were increased, but the really huge increase came from the expansion of the income tax. Leading up to World War II, the income tax had always been a tax on only a few upper income taxpayers. One of the great arguments against the tax had always been that it was a "class" tax – a tax on the wealthy imposed by the masses. As late as 1939, when 7.6 million individual income tax returns were filed, less than six percent of the population was required to file a return. The filing requirement was $5,000 annual gross income. By 1946, the filing requirement had been reduced to $500 annual income, and almost 53 million individual returns were filed. Virtually everyone with a job had become a payer of income tax. The tax on the wealthy classes had become a tax on the masses.

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"No matter what anyone may say about making the rich and the corporations pay the taxes, in the end they come out of the people who toil. It is your fellow workers who are ordered to work for the Government, every time an appropriation bill is passed. The people pay the expense of the government often many times over, in the increased cost of living. I want taxes to be less, that the people may have more."

~ President Calvin Coolidge, 1924

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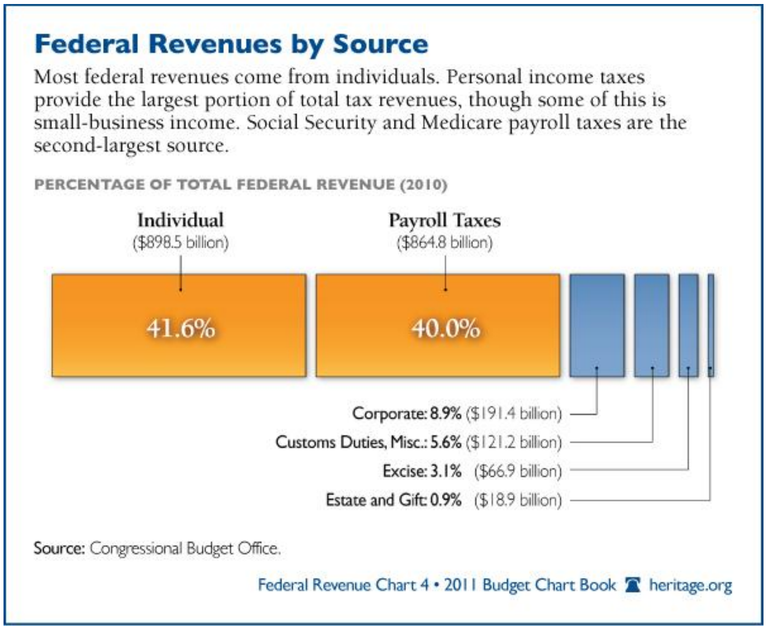
The problem with taxing "the masses," of course, is that its members individually have little money and what they have is more than likely to be spent before the tax collector can get it. An income tax for the masses required a new collection system. Before World War II, the individual income tax was computed annually and paid the following year. A return was filed and the tax was either paid in full at that time or paid in installments over the rest of the year. When Treasury officials requested the big expansion of the income tax in 1941, they also requested that the amounts necessary to pay the previous year's tax be withheld from the current year's payments of wages, interest, dividends and rents. Withholding marked a new phase in the collection of U.S. taxes. Additionally, self-assessment of one's own taxes had grown over the years to be the norm of the federal tax system and the Bureau of Internal Revenue (as it was then called) has almost completely given up actually assessing taxes. With withholding, the Bureau could almost give up collecting taxes since the collecting was being done by the taxpayers themselves.

At the same time, the expansion of the income tax to virtually all workers by the end of World War II meant that the Bureau had become the federal agency with which more Americans had contact than any other. During the Truman Administration, a plan was submitted to Congress in 1952 to transform Internal Revenue completely based on the results of numerous Congressional investigations showing misconduct and fraud within the Bureau. From this point on, there would only be one politically appointed official in the Bureau, the Commissioner, and its function organization structure was changed in both its headquarters and the field with regional commissioners reporting to the Commissioner in Washington. The incoming Eisenhower Administration in 1953 accepted this new structure and completed the reorganization as planned, modifying it only in changed its name to the Internal Revenue Service (IRS).

TYPES OF FEDERAL TAXES



Individual Income Tax

The individual income tax is levied on an individual citizen's income from a variety of sources. From its permanent inception in 1914, tax rates have varied from as low as one percent to as high as 94 percent. It is considered to be a "progressive" tax – one that escalates with income and therefore, disproportionately affects higher earners – because the tax rate is a higher percentage of income for higher-income individuals. Accordingly, the individual income tax has six marginal income tax rates: 10, 15, 25, 28, 33 and 35 percent. Marginal tax rates are the amount of tax paid on an additional dollar of income. As income rises, so does the tax rate.

Please see the current rates and income thresholds below.

Tax Bracket	Married Filing Jointly	Single
10% Bracket	$0 – $17,400	$0 – $8,700
15% Bracket	$17,401 – $70,700	$8,701 – $35,350
25% Bracket	$70,701 – $142,700	$35,351 – $85,650
28% Bracket	$142,701 – $217,450	$85,651 – $178,650
33% Bracket	$217,451 – $388,350	$178,651 – $388,350
35% Bracket	Over $388,351	Over $388,351

Source: 2012 Tax Rate Schedules, Internal Revenue Service (IRS)

Editor's Note: *For a look at the history of U.S. federal individual income tax rates, please click here to see this helpful document published by The Tax Foundation.*

The individual income tax base is composed of wages, salaries, tips, taxable interest and dividend income, business and farm income, realized net capital gains, income from rents, royalties, trusts, estates, partnerships, taxable pension and annuity income and alimony received.

Alternative Minimum Tax (AMT)

The Alternative Minimum Tax (AMT) is a parallel and complex tax system once aimed at ensuring that the rich pay a substantial tax bill. The AMT has a separate and distinct tax calculation that has its own set of rates and rules for the measurement of income and determination of tax deductions. While the regular income tax rates are indexed for inflation, the AMT is not, which has caused an unexpected consequence that increased its reach far beyond its original target of only the richest Americans and onto middle-class earners. As incomes have risen over the years, more and more taxpayers have fallen subject to the AMT and there have been many proposals to fix this problem, but none of them have become law. Each year, Congress, in one way or another, provides a temporary "extension" to prevent more middle-class earners and families from being subject to the AMT.

Payroll Taxes

Payroll taxes are used to fund specific programs, primarily Social Security and Medicare, and are paid by the employee and employer alike (although one could argue the employee pays for all of it since the employer takes the tax amount out of what they have budgeted for the employee's pay). Social Security and Medicare both receive revenues from Federal Insurance Contributions Act (FICA) taxes and Self Employment Contributions Act (SECA) taxes. FICA taxes are paid by both employers and employees, but it is employers who remit the taxes to the Treasury. Employers remit FICA taxes on a regular basis throughout the year, depending on their level of total employment taxes (Social Security, Medicare and federal individual income tax withholding).

The FICA tax rate of 7.65 percent each for employers and employees has two components: 6.2 percent for Social Security and 1.45 percent for Medicare Hospital Insurance (HI). Employers and employees each pay 6.2 percent of covered wages, up to an annual limit (when the Social Security payroll tax rate was 6.2 percent before it was temporarily reduced for 2011 and 2012, the annual limit was $106,800 – more on this temporary rate reduction later…), in Social Security payroll taxes – this is 12.4 percent total. The SECA tax rate is 15.3 percent for self-employed individuals, with 12.4 percent for Social Security and 2.9 percent for Medicare HI. Self-employed individuals pay 12.4 percent of net self-employment income, up to an annual limit (the annual limit for self-employed is the same, but the amount is income rather than wages), in Social Security payroll taxes. One-half of the SECA taxes are allowed as a deduction for federal income tax purposes. SECA taxes are normally paid once a year as part of filing an annual individual income tax return. Unlike Social Security's payroll tax, the Medicare tax has no cap on taxable wages (FICA) or taxable income (SECA).

There is also a payroll tax to support unemployment insurance which is 1.2 percent of the first $7,000 of an employee's income. The taxes gathered by these payroll taxes are already designated for specific federal programs and are not paid into the General Fund of the Treasury to fund the federal government.

Editor's Note: *For a look at the Social Security and Medicare Tax Rates over the years, click here to view the Social Security Administration's (SSA's) compilation.*

In recent Congresses, there have been several changes made to the Social Security payroll tax rate for the purpose of temporary economic/tax relief.

Legislative Action in the 111th Congress

H.R. 2847, Hiring Incentives to Restore Employment (HIRE) Act: In the previous Democrat-controlled 111th Congress, House Democrats hastily assembled and passed a $154 billion bill, H.R. 2847, the Hiring Incentives to Restore Employment (HIRE) Act, that they said was focused on stemming the tide of unemployment and creating jobs. Amongst numerous other provisions, it provided employers with an exemption from the employer's 6.2 percent share of the Social Security payroll tax on wages paid to qualifying employees, effective for wages paid from March 19, 2010, through Dec. 31, 2010. Click here for more information regarding the HIRE Act's tax benefits, per the IRS.

Editor's Note: *For more information on H.R. 2847 and its other provisions, please refer to the Economy and Jobs chapter of the 2012 NRCC Issues Book.*

H.R. 4853, Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010: In December 2010, during the "Lame Duck" session of the 111th Congress, President Obama signed into law H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312). Among its numerous tax extension and tax relief provisions, Title VI of the law provided a temporary two percentage point reduction in the payroll tax rate for employees and the self-employed in 2011. Therefore, for 2011, the Social Security payroll tax rate was 4.2 percent for employees and 10.4 percent for the self-employed. It made no changes to the Social Security payroll tax rate for employers, which remained at 6.2 percent for 2011, or to the amount of annual wages and net self-employment income subject to the Social Security payroll tax ($106,800 in 2011).

This reduction was intended to provide an "economic stimulus" by increasing workers' take-home pay. For example, the annual Social Security withholding for a worker earning the average wage in 2011 (an estimated $44,687) was lowered allowing workers to take home $894 more than before the rate reduction. To protect the Social Security Trust Fund from a loss of payroll tax revenues resulting from the temporary reduction in the payroll tax rate for employees and the self-employed, the law also appropriated to the Trust Fund amounts equal to the reduction in payroll tax revenues to the Treasury. The Congressional Budget Office (CBO) estimated in August 2011 that general revenue transfers to the Social Security trust funds as a result of this temporary payroll tax reduction in 2011 totaled $111 billion.

Legislative Action in the 112th Congress

With the impending expiration of the 2011 Social Security payroll tax rate of 4.2 percent, beginning in November 2011, there were several different proposals for another Social Security payroll tax holiday tossed around in both the House and Senate.

H.R. 3630, Middle Class Tax Relief and Job Creation Act of 2011: Following the failure of two proposals to extend the payroll tax holiday in the Senate, in the House, Rep. Dave Camp (R-Mich.), chairman of the House Ways and Means Committee, introduced H.R. 3630, the Middle Class Tax Relief and Job Creation Act of 2011. Among numerous other provisions, this broad measure would have extended for one year the two percentage point reduction in the Social Security payroll tax for workers. It would not have also provided a payroll tax reduction for employers, which was proposed by both President Obama and Senate Democrats as a possibility. Not only would H.R. 3630 have provided general revenue transfers to the Social Security Trust Fund to make up for the loss of revenue resulting from the rate cut, it would have offset the cost of the cut by extending the current pay freeze for federal employees and making changes to civilian federal pension benefits (in brief, the proposal would have increased employer contributions, which included Members of Congress, to their pension plans).

Editor's Note: *H.R. 3630 had numerous other provisions dealing with unemployment insurance reform, food stamp and Medicare reform, etc. Please contact the NRCC for more information regarding the details of these other provisions.*

H.R. 3630 passed the House on Dec. 13, 2011, by a vote of 234-193. To see how they voted, click here.

H.R. 3630, Temporary Payroll Tax Cut Continuation Act of 2011: On Dec. 17, 2011, the Senate passed H.R. 3630, with an amendment in the nature of a substitute, by a vote of 89-10, which completely changed the House-passed version (even renaming it), by extending the payroll tax holiday for workers for two months (for January and February 2012). The Senate-amended version also did not provide any offsets.

Motion to Disagree to the Senate Amendments to H.R. 3630 and Request a Conference with the Senate: On Dec. 20, 2011, the House voted 229 to 193 to disagree with the Senate-passed version of H.R. 3630 and request a conference with the Senate to resolve differences between the House- and Senate-passed versions of H.R. 3630. House Republicans felt that a two-month extension, as opposed to a full-year extension, and one that was not offset, was irresponsible and might make things difficult for employers and families trying to plan their finances and budget for the entire year of 2012.

H.R. 3765, Temporary Payroll Tax Cut Continuation Act of 2011: On Dec. 23, 2011, Rep. Camp introduced H.R. 3765 which extended the two percentage point reduction in the Social Security payroll tax for workers for two months (through Feb. 29, 2012). It was offset by increasing fees charged by government-sponsored enterprises (GSEs) to lenders for assuming the credit risk on loans in the secondary mortgage market. H.R. 3765 passed both the House and Senate by voice vote on Dec. 23, 2011 and was signed into law by President Obama (P.L. 112-78).

Conference Report on H.R. 3630: Following a veritable "legislative standoff," on Feb. 17, 2012, the House passed the conference report on H.R. 3630, by a vote of 293-132. Click here to see how they voted. President Obama signed it into law on Feb. 22, 2012. Among other provisions, it extended the two percentage point reduction for workers through the end of 2012. This extension, as well as its inclusion of a "fix" for scheduled reductions in Medicare reimbursement rate for physician services, were offset through various methods including: broadband spectrum auctions, reduction of some funding available for the 2010 Democrats' health care overhaul law and increasing the contribution amount for federal civilian employees (including Members of Congress) to their pension plans.

Editor's Note: *For more information regarding the multitude of provisions in this conference report, please contact the NRCC.*

Business Taxation

Businesses can take a variety of forms, ranging from large, publicly held corporations ("C" corporations), to more closely held corporations ("S" corporations), to partnerships (large and small), to firms that are run by only a single self-employed owner. According to the Congressional Budget Office (CBO), 62 percent of tangible business assets are owned by C corporations – the remainder, 38 percent, is owned by partnerships, sole proprietorships and S corporations. The rules for determining taxable income are the same, regardless of the type of business. But, the way in which income is taxed, however, varies depending on the type of business.

"S" corporations: Income earned by relatively closely held corporations – termed "S" corporations – is generally not subject to the corporate income tax. Instead, an S corporation's income is "passed through" to the firm's stockholders and taxed to them under the individual income tax, regardless of whether the income is actually distributed. To be eligible to be an S corporation, a corporation may not have more than 100 shareholders and may not have more than one class of stock.

Partnerships: Like S corporations, partnership taxable income is not subject to a business-level tax like the corporate income tax. Instead, each partner is taxed under the individual income tax on his or her share of its profit.

Sole proprietorships: Individual income taxes also apply to business income earned by self-employed persons who operate sole proprietorships. As with partnerships and S corporations, no separate tax is applied at the business level.

Corporations / "C" corporations: Income earned by large, publicly held corporations, or "C" corporations, is generally subject to the corporate income tax along with the individual income tax, the estate and gift tax, excise taxes and Social Security taxes. Conceptually, the U.S. corporate income tax applies as though corporations are entities with an existence separate from their owners, the stockholders. The tax applies to taxable corporate income, corporate profits (after deducting interest) as defined by the tax code. It applies separately and in addition to the individual income tax's applicability to shareholder's dividends and capital gains. In general, this means that income subject to the corporate income tax is taxed twice – once under the corporate income tax in the hands of corporations and once under the individual income tax when stockholders receive dividends or realize capital gains. Double taxation does not apply, however, in the case of corporate income generated by debt-financed investment (since the return is paid to creditors as interest and is tax-deductible) and does not apply regarding income paid to tax-exempt stockholders (i.e. pension funds).

Like the individual income tax, corporate taxable income is subject to a set of graduated rates: 15 (for taxable income up to $50,000), 25 ($50,001 to $75,000), 34 ($75,001 to $10,000,000) and 35 percent ($10,000,001 and over), with the lower rates applying to firms with lower taxable incomes. The bulk of corporate income is earned by large firms, which is subject to either the 34 percent or 35 percent rate. The base of corporate income tax is net income, or profits, as defined by the tax code. In general, this is gross revenue minus costs. Deductible costs include materials, interest and wage payments. Another important deductible cost is depreciation – an allowance for declines in the value of a firm's tangible assets, such as machines, equipment and structures.

As of this writing, the United States has the highest statutory corporate tax rate in the world. The statutory rate is both federal and state rates combined. Japan used to have this distinction with a statutory rate of 39.8 percent, but it recently cut its rate to 36.8 percent. The United States' statutory corporate tax rate is 39.2 percent. Additionally, though, the U.S. effective corporate tax rate of 35 percent is actually only about 29 percent following loopholes, etc. – this puts the United States' effective corporate tax rate below the average of 31.9 percent among other major economies, according to the U.S. Treasury Department. There is near unanimous bipartisan agreement in Washington that the U.S. corporate tax rate is out of step with rates levied by most industrialized nations and that America's global competitiveness is suffering as a result.

Despite concerns expressed about the size of our corporate tax rate, current corporate taxes are extremely low by historical standards, whether measured as a share of output or based on the effective tax rate on income. In 1953, the corporate tax rate accounted for 5.6 percent of gross domestic product (GDP) and 30 percent of federal tax revenues. In recent years the tax has fluctuated around two percent of GDP and 10 percent of revenues, reaching a low of 1.2 percent of GDP in 2003, and standing at 2.7 percent in 2006. Today, it is the third largest federal revenue source, lagging behind the individual income tax, which was about eight percent of GDP, and the payroll tax, which was about 6.5 percent in 2006.

Excise Tax

Excise taxes are a form of consumption tax – levies on the consumption of goods and services rather than income. Unlike sales taxes, they apply to particular commodities, rather than to broad categories. The major federal excise taxes are levied on transportation fuels, alcohol, tobacco, telephones and domestic air transport.

Estate and Gift Tax

Better known as the "death" tax, the controversial federal estate tax is imposed when property is transferred at death. The base is subject to graduated rates that rise from 18 percent to 45 percent as estate size increases. An unlimited marital deduction is allowed for property transferred to a surviving spouse. Other allowable deductions include estate administration expenses, transfers to charity and certain other items. The federal gift tax operates alongside the estate tax to prevent individuals from avoiding the estate tax by transferring property to heirs before dying. The estate tax remains a controversial topic as many feel that an estate tax, indexed at any income level, is unfair, constitutes double taxation on income that has already been taxed and hurts small businesses and farms.

WHO PAYS?

Sometimes lost in the debate over marginal income tax rates, income thresholds, exemptions, deductions and so on, is the question of who is actually paying these taxes? The question is particularly relevant these days, as deficits pile up, demands for government spending soar and many of the past decade's tax cuts near their expiration in 2012. The answer is revealing. The highest earners pay the lion's share of the dollars Uncle Sam collects and a surprisingly high number of citizens end up owing very little, if anything at all.

Taxpayers can take advantage of a variety of deductions and tax exemptions on their income taxes. They can take a standard deduction (a fixed dollar amount that reduces the amount of income on which you pay tax on your tax return) or they may itemize their deductions. The elderly and blind are allowed an additional standard deduction. Itemized deductions are allowed for home mortgage interest payments, state and local income taxes, state and local property taxes, charitable contributions, excessive medical expenses and a few other items. The tax base is reduced further by subtracting personal and dependent exemptions, which are allowed for the taxpayer, his or her spouse and each dependent. For higher income taxpayers, these exemptions are phased out.

Due to the amount of deductions and exemptions available, many Americans have an effective tax rate of zero percent. According to The Tax Foundation, in 2009 (based on most recent available IRS tax data) 41.7 percent of all federal individual income tax returns had zero or negative tax liability. In fact, the highest earners pay the most by a long shot. In 2009, the top 10 percent of earners paid nearly 71 percent of all federal income taxes, according to the most recent data available from the IRS. Narrowing in even further, the top one percent of households paid nearly 37 percent of all individual income taxes.

Summary of Federal Income Tax Data, 2009

	Number of Returns with Positive AGI	AGI ($ millions)	Income Taxes Paid ($ millions)	Group's Share of Total AGI	Group's Share of Income Taxes	Income Split Point	Average Tax Rate
All Taxpayers	137,982,203	$7,825,389	$865,863	100.0%	100.0%	-	11.06%
Top 1%	1,379,822	$1,324,572	$318,043	16.9%	36.7%	$343,927	24.01%
1-5%	5,519,288	$1,157,918	$189,864	14.8%	22.0%		16.40%
Top 5%	6,899,110	$2,482,490	$507,907	31.7%	58.7%	$154,643	20.46%
5-10%	6,899,110	$897,241	$102,249	11.5%	11.8%		11.40%
Top 10%	13,798,220	$3,379,731	$610,156	43.2%	70.5%	$112,124.00	18.05%
10-25%	20,697,331	$1,770,140	$145,747	22.6%	17.0%		8.23%
Top 25%	34,495,551	$5,149,871	$755,903	65.8%	87.3%	$66,193.00	14.68%
25-50%	34,495,551	$1,620,303	$90,449	20.7%	11.0%		5.58%
Top 50%	68,991,102	$6,770,174	$846,352	86.5%	97.7%	> $32,396	12.50%
Bottom 50%	68,991,102	$1,055,215	$19,511	13.5%	2.3%	< $32,396	1.85%
Source: Internal Revenue Service/The Tax Foundation							

A recent Tax Foundation survey found that 56 percent of Americans think the amount of federal income tax they pay is too high. Those most likely to feel that way, according to the survey, include those making $35,000 and $50,000 annually. However, once the various tax breaks to which they are entitled are counted, the burdens of low- and middle-income tax filers as a group has been fairly low.

THE 2001 AND 2003 TAX CUTS

The tax cuts enacted between 2001 and 2006 contain a host of large and small changes to the tax code that phase in at different rates and expire at different times. The tax cuts of 2001, 2003, 2004, 2005 and 2006 built on one another, with many of the bills passed after 2001, serving to extend provisions in earlier bills. The combination of the 2001 and 2003 bills are what are most often referred to as the "2001 and 2003 Tax Cuts," as these bills contained the most substantive changes to the tax code. Most provisions are now scheduled to expire at the end of 2012.

The 2001 and 2003 tax cut bills cut income tax rates, dividend tax rates and the capital gains tax, reduced the estate and gift taxes to zero in 2010, expanded the earned income tax credit, reduced the marriage penalty, expanded the child tax credit and allowed small businesses to deduct a more generous share of their expenses. Those are just the big ones.

The 2001 tax cut focused on immediate cuts in wage taxes for low- and middle-income people, especially: creating a ten percent tax bracket and mailing each taxpayer a check for the current year's savings, raising the ceiling of the 15 percent bracket to protect middle-income couples from the marriage penalty and raising the child tax credit from $500 to $1,000 and making it refundable.

The legislation did include tax cuts at the high end of the income spectrum, but those were scheduled to phase in over many years. The top income tax rate of 39.6 percent was only cut to 39.1 percent in the first year. No positive economic impact was noticeable during 2002 and pressure built for a supply-side tax cut. That was delivered in May 2003 in the form of an acceleration of the 2001 phase-ins, plus a new 15 percent tax rate on capital gains (down from 20 percent) and a 15 percent rate on dividends (down from a high of 39.6 percent).

A brief year-by-year summary of the Tax Cuts:

- The 2001 tax cut was especially sweeping. Its two most prominent changes were a phased-in reduction in income tax rates, the creation of a new low-income 10 percent tax bracket, and a reduction and eventual repeal (at the beginning of 2010) of the estate tax. It also provided a wide range of tax breaks for education, families with children, married couples, and contributions to certain kinds of savings accounts.

  Editor's Note: *Since the provisions of the 2001 tax cut were set to sunset after 2010, in 2011 the estate tax was scheduled to return to rates scheduled prior to the 2001 tax cut (exemption of first $1 million of estate from tax and a top tax rate of 55 percent). But, the December 2010 tax cut extension package (which will be explained in the next section of this chapter) established the $5 million exemption and 35 percent rate for 2010 and 2011. Absent legislative action, the estate tax rate and exemption will return to pre-2001 tax cut levels in 2013.*

- The 2002 tax cut addressed a different part of the tax code significantly, but temporarily reducing the tax burden on new business investments. Its main provision has already expired.

- The 2003 bill cut taxes on dividends and capital gains and accelerated the schedule for phasing in most of the other tax cuts enacted in 2001.

- The 2004 tax cut extended various provisions from the 2001 and 2003 tax cuts that were scheduled to expire before 2010, so that they remained in force through 2010.

- The 2005 tax cuts indexed the alternative minimum tax (AMT) for inflation for one year ("patched" it, in tax parlance), eliminated the income restrictions on Roth Individual Retirement Accounts (IRAs) in 2010, and extended the reduced rates on dividend and capital gains income.

- The 2006 tax cuts made certain aspects of the 2001 tax act permanent, including the raised annual contribution limits to IRAs, tax-free withdrawals from qualified tuition savings accounts, and the savers' credit, and permanently extended rules governing education-based tax credits.

2010 Extension of the 2001 and 2003 Tax Cuts

Most of the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRAA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRAA) were scheduled to expire at the end of 2010 unless Congress acted to extend them. According to the Tax Policy Center, if the cuts had expired as scheduled, nearly three-quarters of Americans would have paid more tax in 2011 and subsequent years.

The 2001 tax law (P.L. 107-16) is considered a signature domestic policy achievement of President George W. Bush, and was the second biggest tax cut in history. The law made numerous changes to tax laws that reduced federal revenue by an estimated $1.35 trillion over 10 years. The law reduced income tax rates across the board, with the top rate reduced from 39.6 percent to 35 percent; created a new 10 percent rate that initially applied to the first $6,000 of income for individuals and $12,000 for couples; reduced the "marriage penalty;" doubled the child tax credit to $1,000; and repealed the estate tax for 2010 after cutting the top rate from 55 percent to 45 percent.

The second round of tax cuts under a 2003 law (P.L. 108-27) – which made up the third largest tax cut in U.S. history – provided tax breaks and aid to the states totaling $349.7 billion over 11 years. The measure reduced tax rates on both dividends and capital gains to 15 percent for most taxpayers, and eventually to zero percent for those in the lowest tax brackets. It also included $20 billion in direct assistance to the states and reduced taxes for businesses by $10.1 billion over the next 11 years.

The major provisions in the two laws were scheduled to expire on Dec. 31, 2010. The debate over whether to extend the tax cuts, and to whom, was a dominant issue throughout the 111th Congress and the 2010 election cycle.

The Lame Duck Session: President Obama campaigned in 2008 on extending the reduced tax rates only for those taxpayers who make less than $250,000, arguing that it would not be just to provide tax breaks to the wealthiest Americans while many others were struggling. A number of Democrats agree with that position and have supported an extension of the tax cuts only for those making less than $250,000 per year. After the historic wins by the GOP in the 2010 mid-term elections, however, President Obama signaled that he was open to compromise during an anticipated "lame duck" session of Congress, including temporarily extending all of the Bush-era tax cuts.

Oddly, House Democratic leaders decided to hold a vote on a permanent extension of the tax cuts – but only for incomes up to $200,000 for individuals and up to $250,000 for couples. On December 2, 2010, by a vote of 234 to 188, House Democrats voted to approve that plan. You can see how they voted here.

The measure would have permanently extended reduced tax rates and other tax benefits enacted in 2001 and 2003 for adjusted gross income of up to $200,000 for individuals and $250,000 for married couples. It also would have provided a two-year "patch" to prevent the AMT from affecting 25 million taxpayers and permanently extended increased expensing rules for small businesses. According to the Joint Committee on Taxation (JCT), that measure would have reduced revenue by a total of $1.5 trillion over 10 years.

The Compromise: On Dec. 6, 2010, President Obama announced that White House officials and congressional leaders had reached an agreement on the tax cut extensions. The eventual package included a two-year extension of the Bush tax cuts for all income levels, a two-year reduction of the maximum estate tax rate (but an increase up from zero that the estate tax had reached under current law – the "death" tax was eliminated for 2010), a one-year, two-percentage-point reduction in the payroll tax paid by employees and a 13-month extension of unemployment insurance. Other major provisions include a two-year "patch" to the AMT to ensure that it did not hit thousands of additional middle-income taxpayers, renewal of the research and development (R&D) tax credit and a two-year provisions allowing small businesses to deduct all or part of the cost of investments in the year they are placed in service.

The House passed the package, H.R. 4853, on Dec. 17, 2010, by a vote of 277 to 148 (R: 138-36; D: 139-112). You can see how they voted here.

Highlights of the Tax Package Signed Into Law:

Editor's Note: *The following is courtesy of Congressional Quarterly.*

> The following are the major provisions of the tax package that President Obama signed Dec. 17 (H.R. 4853, PL 111-312). None of the costs — totaling $857.8 billion over 10 years — are offset.
>
> **2001 & 2003 tax cuts**
> The bill extends provisions of the 2001 and 2003 tax laws for all income levels for two years (2011-12) at a cost of $407.6 billion over 10 years — more than 45 percent of the total cost of the bill. The extensions include:
>
> - Lower marginal income tax rates, including continuation of the 10 percent bracket.
> - 15 percent maximum rate for capital dividends (20 percent of those with incomes above).
> - Maximum child tax credit of $1,000 as well as expanded eligibility for the refundable credit.
> - Relief from the so-called marriage penalty by increasing the standard deduction for married couples filing jointly.

- Simplified rules and expanded eligibility for the Earned Income Tax Credit.

AMT 'Patch'
A two-year "patch" increases the amount of income that is exempt and allows various non-refundable personal credits to be claimed against the alternative minimum tax. The purpose is to prevent an estimated 25 million additional taxpayers from falling under the AMT. The 10-year cost is estimated at $111.7 billion.

Estate Tax
The estate tax, which was temporarily repealed at the end of 2009, will be reinstated for two years at a maximum top rate of 35 percent and an exemption level of $5 million, with an estimated 10-year cost of $68.1 billion.

Tax 'Extenders'
The measure extends a number of expired tax provisions at a total 10-year cost of $55.3 billion.

Tax breaks extended for 2010 and 2011 include:

- The research and experimentation credit.
- A deduction for state and local sales taxes in lieu of state income taxes.
- An above-the-line deduction for qualified education expenses.
- Tax incentives for biodiesel and renewable diesel fuel "blenders."

Items extended for 2011-13 include:

- Income tax credits for alcohol fuels.
- Grants, in lieu of tax credits, for certain energy property that is part of a qualified renewable-electricity production facility or is otherwise eligible for an energy credit.

Unemployment Insurance
The bill extends for 13 months, through the end of 2012, expanded federal unemployed insurance benefits for jobless workers who have exhausted their state benefits, at an estimated 10-year cost of $56.5 billion.

Business Taxes
For 2011, small businesses can deduct the full cost of investments in the year the items are placed in service, rather than depreciate the cost over time. For 2012, they can write off up to $125,000, a benefit that phases out after investments exceed $500,000. The cost is estimated at $21.8 billion over 10 years.

Payroll Tax Reduction
Employees' half of the payroll tax is reduced to 4.2 percent from 6.2 percent. Self-employed individuals will pay a 10.4 percent rate instead of 12.4 percent. The estimated 10-year cost is $111.7 billion.

TAX CODE COMPLEXITY AND THE NEED FOR REFORM

★★★★★★★★★★
"Would it not be better to simplify the system of taxation rather than to spread it over such a variety of subjects and pass through so many new hands?"

~ Thomas Jefferson in letter to James Madison, 1784
★★★★★★★★★★

The main intent of the tax code is to provide revenue for the federal government. However, the tax code is frequently used to achieve social, economic, and political goals. For example, the deduction for mortgage interest expense on primary residences is an attempt to encourage home ownership. Yet, because the government uses the tax code as an instrument of social policy, the code has grown in size and complexity while lacking a central organizing principle. According to the National Taxpayer Advocate, a division of the IRS, the complexity of the code is the most serious tax problem facing taxpayers. Fundamental overhaul of our tax system remains a critically-important goal. As the Internal Revenue Code becomes increasingly incomprehensible, the intrusive measures provided to the IRS for enforcing it seem to become more draconian. Every detail of a taxpayer's private financial life is open for government inspection. IRS employees can make extraordinary demands on taxpayers, and can take extraordinary actions against them. Mixing such broad powers with a vague and complex law is a recipe for a civil liberty catastrophe. The threat of abuse is always present.

Many proposals have been suggested regarding federal tax reform ranging from a broader-based, flat-rate income tax to a national sales tax to replace the current system, to more incremental changes or identifying additional revenue-raising options. Whatever the solution, most Members of Congress agree that significant reform of the current federal tax system is needed. However, enacting any major reform will require momentous bipartisan support as the current popular tax reform proposals all contain their share of significant political ramifications.

The following tax reform proposals are just a select few of the numerous suggestions out there.

Editor's Note: *The following summaries are not in-depth analysis of each proposal – they are very brief "quick looks" at each one. For more in-depth analyses of any tax reform proposals, please contact the NRCC.*

FairTax

The basic concept of the FairTax is to eliminate the current federal tax code including payroll, income, corporate, Social Security, every other tax, and substitute a 23 percent national retail sales tax on nearly all goods and services. The FairTax also includes a complicated rebate system designed to help shield the working poor.

There is a lot to be said for taxing consumption over income, and for many, the FairTax certainly has merit. However, the plan produces a litany of political problems for candidates.

While proponents use that 23 percent figure as an easier political sell, the rate is closer to 30 percent when it's calculated like any other sales tax, with the levy on top of the price. State sales levies would go on top of that.

The plan would require repealing the Sixteenth Amendment to the Constitution, which gives the federal government the right to collect an income tax. Given the complexity of amending the Constitution, such a change is extremely unlikely. The risk is that we would end up with both an income tax and a national sales tax – a true double taxation.

Another problem with a national sales tax is that its rate would have to be very high to raise enough money to fund the government. A rate of 30 percent, or even 23 percent, would not be permanent, and could easily be increased by Congress citing "need."

As a political matter, the FairTax provides a major opening for Democrats who would love to run a campaign against a supporter of a plan that would instantly make most purchases 30 percent more expensive. The FairTax would also tax medical services and home prices, definite political hot buttons. Finally, no matter how you look at it, a tax on consumption would nonetheless hit hard the young and middle-income.

For examples of how FairTax supporters have been attacked in previous campaigns, please view the following advertisements:

- http://www.youtube.com/watch?v=dfuK9Df7F0o
- http://www.youtube.com/watch?v=2nuqYVRbe-U&feature=channel
- http://www.youtube.com/watch?v=iVA9XVJ3P-A&NR=1

Flat Tax

Compared to the current system, a flat tax is extremely simple. A flat tax would treat people equally. A wealthy taxpayer with 1,000 times the taxable income of another taxpayer would pay 1,000 times more in taxes. All flat tax proposals have a single rate, usually less than 20 percent. Flat tax proposals would eliminate provisions of the tax code that bestow preferential tax treatment on certain behaviors and activities. Proponents contend that getting rid of deductions, credits, exemptions, and other loopholes also helps solve the problem of complexity, allowing taxpayers to file their tax returns on a postcard-sized form.

However, like the FairTax, political problems could abound. Flattening out the current progressive income tax system, while cutting taxes for many, would necessarily increase taxes for those on the lower end of the income spectrum. It can be framed as cutting taxes for the rich, while increasing taxes on the poor. Another issue is the rate at which a flat tax would have to assume in order to reduce budget deficits could be extremely high relative to the current rate for most taxpayers. Further, no flat tax proposals currently address payroll taxes, which finance Social Security, Medicare and other entitlement programs, so these taxes would remain. There is also concern that the elimination of popular deductions could have a negative effect on charities and homeowners, who would lose their current tax advantages.

Value-Added Tax (VAT)

The Value-Added Tax (VAT) is a consumption-based sales tax, but one that is very complicated compared to a "traditional" sales tax. VATs are common in other countries, especially within the European Union. A VAT is similar to a national retail sales tax, but is collected at every stage of business production until its entire burden ultimately falls on the consumer.

Consider this example using our old economics buddy, the “widget”:

I’m a consumer that goes to the store to by a widget that today cost $1. A new VAT has been imposed in my country at a 10 percent rate. Along the supply chain you have a supplier (the stuff to make the widget), a producer (the maker of the widget) and a retailer (to sell the widget).

The supplier sells the items to make the widget to the producer for 20 cents. The VAT is two cents. The producer pays the supplier 22 cents, and the supplier sends two cents in VAT to the government.

The producer makes a widget and sells it to the retailer for 60 cents. The VAT is six cents. Now the retailer pays the producer 66 cents, of which six is VAT. The producer sends the government four cents -- he pays six cents in VAT, but receives a two-cent credit from the government for the earlier payment.

The retailer sells the widget to me for a dollar plus the final tax. I pay $1.10. The retailer sends the government four cents total - the 10 cents it collected in VAT on its sales, minus the six cents it paid to the producer in VAT, which it gets back in a credit. In total, the government gets two cents from the supplier, four cents from producer, and four cents from the retailer. That is 10 cents on a final sale of a dollar -- for a 10 percent VAT.

If you note, at the end of the day, the end consumer (me) pays 10 cents more for a product than I would have normally. Even though consumers are not taxed directly, the above example explains how the VAT is ultimately borne by consumers in the form of higher prices for goods.

According to the European Commission Taxation and Customs Union, a VAT is:

- A general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services.

- A consumption tax because it is borne ultimately by the final consumer. It is not a charge on businesses.

- Charged as a percentage of prices, which means that the actual tax burden is visible at each stage in the production and distribution chain.

- Collected fractionally, via a system of partial payments whereby taxable persons (i.e., VAT-registered businesses) deduct from the VAT they have collected the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved.

- Paid to the revenue authorities by the seller of the goods, who is the “taxable person”, but it is actually paid by the buyer to the seller as part of the price. It is thus an indirect tax.

Although interest in the VAT is growing amongst some in Washington (the White House even subtly floated a “test balloon” on the Sunday political talk shows in early 2009), the tax has three glaring political problems. First, it’s a regressive tax: low-earning families would pay a bigger portion of their incomes than the wealthy on any kind of consumption tax, but especially a VAT which has the potential to raise the costs of good significantly. Second, generally speaking, a VAT is applied on top of an existing income tax structure. In the United States, absent the unlikely repeal of the 16th Amendment to the Constitution, a VAT would concurrently operate alongside the federal income tax code. Finally, the VAT in other countries has fueled the rapid growth of government in France, Germany, and even Japan.

THE TAX TREATMENT OF HEALTH CARE

Health insurance premiums paid by employers are fully excluded from their employees' federal income tax (as well as from their payroll taxes); while premiums paid by individuals who are not provided employer-sponsored insurance receive far less generous tax treatment. The current employer-based health system, rooted in the favorable tax treatment provided to employer-sponsored insurance, has both advantages and disadvantages. The tax code's substantial subsidy for employer-sponsored insurance has had a number of positive effects, such as broad coverage, greater risk-pooling opportunities, and considerable administrative savings. However, the current tax treatment also has some serious drawbacks:

- There is no corresponding, broadly-available tax benefit for those who purchase coverage in the individual market; providing a comparable benefit would help cover many of the uninsured.

- Because employees with employer-sponsored insurance do not face the full cost of care and have little incentive to question care paid for by third-party insurance, the current tax exclusion encourages unnecessary coverage, leading to higher health care costs for all Americans.

- Because the value to the employee of the current exclusion depends on income level, low-income workers get less "bang for their buck" from the tax code than high-income workers.

- Employees, especially those with chronic illnesses or sick dependents, may not pursue other, more preferable jobs for fear of losing their employer-sponsored health coverage.

RECENT REFORM ACTIVITY AND PROPOSALS

Simpson-Bowles

In December 2010, President Obama's bipartisan National Commission on Fiscal Responsibility and Reform, or Simpson-Bowles as it is sometimes known after its co-chairs, issued its report titled, *The Moment of Truth*, which proposed extensive broadening of both the individual income tax base and the corporate income tax base by eliminating all business tax expenditures and almost all individual tax expenditures. Marginal individual and corporate income tax rates would be reduced and the individual AMT would be abolished. The taxation of foreign-source income would be changed by moving to a territorial system.

Bipartisan Policy Center

On Nov. 17, 2010, the Debt Reduction Task Force of the Bipartisan Policy Center issued a report, authored by former Senator Pete Domenici (R-N.M.) and former Clinton Administration CBO and OMB Director Alice Rivlin, titled, *Restoring America's Future*. This report also recommended that individual and corporate income tax bases be broadened by reducing or eliminating most tax expenditures. Marginal individual and corporate income tax rates would be lowered, and the individual AMT would be eliminated. In addition, this report recommended that a 6.5 percent VAT be levied.

H. Con. Res. 34, FY 2012 House Budget Resolution

On April 14, 2011, House Budget Committee Chairman Paul Ryan (R-Wis.) introduced H. Con. Res. 34, which included major tax reforms. Click here to view the full bill text.

On April 15, 2011, H. Con. Res. 34 passed the House by a vote of 235 to 193. Click here to see how they voted. This budget resolution for FY 2012 proposed to reduce future deficits and slow the growth of the national debt. The summary regarding taxes states that the budget resolution:

- keeps taxes low so the economy can grow, eliminates roughly $800 billion in tax increases imposed by the President's health care law, and prevents the $1.5 trillion tax increase called for in the President's budget; and

- calls for a simpler, less burdensome tax code for households and small businesses, lowers tax rates for individuals, businesses and families, sets top rates for individuals and businesses at 25 percent and improves incentives for growth, savings and investment.

Editor's Note: *For more information regarding the FY 2012 House Budget Resolution, please refer to the Budget and Federal Spending chapter of the 2012 NRCC Issues Book.*

President Obama's "Framework for Shared Prosperity and Shared Fiscal Responsibility"

On April 13, 2011, President Obama presented his "Framework for Shared Prosperity and Shared Fiscal Responsibility" in a speech which proposed to reduce the deficit by $4 trillion over 12 years or less. This plan included comprehensive tax reform. The fact sheet for his proposal states:

"The President is calling on Congress to undertake comprehensive tax reform that produces a system which is fairer, has fewer loopholes, less complexity, and is not rigged in favor of those who can afford lawyers and accountants to game it.

"He believes we cannot afford to make our deficit problem worse by extending the Bush tax cuts for the wealthiest Americans.

"He also supports efforts to build on the Fiscal Commission's goal of reducing tax expenditures so that there is enough savings to both lower rates and lower the deficit. Reform should be designed to ask more of those who can afford it while protecting the middle class and promoting economic growth.

"In addition, as he explained in the State of the Union, the President is continuing his effort to reform our outdated corporate tax code to enhance our economic competitiveness and encourage investment in the United States. By eliminating loopholes, reducing distortions and leveling the playing field in our corporate tax code, we can use the savings to lower the corporate tax rate for the first time in 25 years without adding to the deficit."

House Ways and Means Committee Chairman Dave Camp's International Tax Reform Discussion Draft

The current system of U.S. taxation of international business is complex and difficult to administer. Furthermore, critics argue that the current system is not sufficiently neutral, which results in economic inefficiency. There have been proposals to reform the system including replacing it with a territorial tax system, which is what Chairman Dave Camp (R-Mich.) of the House Ways and Means Committee proposed in October 2011.

In addition to proposing to lower top tax rates for both individuals and employers to 25 percent, the plan proposed to transition the United States from a worldwide system of taxation to a territorial system.

Click here to view the discussion draft.

Below is a summary of Chairman Camp's proposal, provided by the House Ways and Means Committee:

- Makes clear that tax reform will reform the individual income tax by providing simplification, fairness, and stronger incentives to work, invest, and create jobs for families and small businesses. (Specific policies are not explicitly identified in the discussion draft.)

- Reduces U.S. corporate tax rate to 25%, making the United States a more attractive place to invest and create jobs. (Specific base broadening policies that will accompany the 25% rate are not explicitly identified in the draft.)

- Exempts 95% of certain foreign-source income from U.S. tax. The exemption applies to dividends paid by foreign companies to U.S. corporate shareholders owning at least 10% of the shares. It also applies to capital gains from sales of shares in foreign companies by 10% U.S. corporate shareholders. The 10% ownership test distinguishes active participants in a business from portfolio investors.

  - Thus, the effective U.S. tax rate on most foreign dividends would be 1.25% (25% rate multiplied by the 5% of income that is not exempt) – putting American companies on a more level playing field with foreign competitors and ending the "lock-out effect" that discourages these companies from bringing foreign earnings back to the United States.
  - Dividends and capital gains from foreign companies that are less than 10% owned by domestic corporations would be treated the same as under current law.

- Includes a number of anti-abuse rules to prevent erosion of the U.S. tax base and help make the participation exemption system a revenue neutral component of tax reform, such as:
  - Anti-deferral rules ("subpart F") that immediately and fully tax domestic companies on the passive income of foreign companies.
  - Thin capitalization rules that prevent U.S. companies from borrowing heavily in the United States (generating tax deductions to reduce taxes on their U.S. income) to finance income from overseas operations (which is eligible for the 95% exemption).
  - Income shifting rules that prevent U.S. companies from avoiding U.S. tax by transferring highly valuable intangible property to foreign companies that pay little or no tax.
- Foreign tax credits still would be available to mitigate double taxation of non-exempt foreign income - such as passive income and royalties.
- All pre-effective date, tax-deferred foreign earnings of foreign companies owned by 10% U.S. shareholders would be taxed once at a low tax rate (similar to a repatriation holiday). U.S. companies could pay this tax ratably over eight years, and these earnings could then be brought back to the United States under the exemption system.

President's Council on Jobs and Competitiveness 2011 Year-End Report

Formed originally in February 2009, the President's Economic Recovery Advisory Board's charter was renewed and renamed as the President's Council on Jobs and Competitiveness in February 2011 with a "new focus on economic competitiveness." In its most recent 2011 Year-End Report entitled, "Road Map to Renewal: Invest in Our Future, Build On Our Strengths, Play to Win," one of the Council's recommendations to "help catalyze job growth" was to lower the corporate tax rate and broaden the tax base.

President Obama's FY 2013 Budget Proposal

On Feb. 13, 2012, President Obama released his FY 2013 budget proposal, which contained tax proposals. The full proposal can be found here.

Specifically, regarding tax reform, the President's budget proposes to:

- "*Simplify the Tax Code and Lower Tax Rates.* The tax system should be simplified and work for all Americans with lower individual and corporate tax rates and fewer tax brackets.

- "*Reform Inefficient and Unfair Tax Breaks—Eliminating Them for Millionaires While Making All Tax Breaks at Least as Good a Deal for the Middle Class as for Wealthy Americans.* Reform should cut and simplify tax breaks that are now inefficient, unfair, or both, so that wealthiest Americans cannot avoid their responsibilities by gaming the system, that middle class working Americans receive their fair share, and that Americans can spend less time and money each year filing taxes. That means eliminating tax subsidies for millionaires that they do not need; there is no reason that those making over $1 million should get any tax subsidies for housing, health care, retirement, and child care. And it means ensuring fair incentives for the middle class to buy a home or save for retirement, as opposed to allowing the most well-off to get two to three times as much.

- "*Decrease the Deficit While Protecting Progressivity.* Reform should cut the deficit by $1.5 trillion over the next decade through tax reform, including the expiration of tax cuts for single taxpayers making over $200,000 and married couples making over $250,000. And it should do this while keeping the tax code at least as progressive as if the high-income 2001 and 2003 tax cuts were eliminated, as the President proposes.

- *Increase Job Creation and Growth in the United States.* The tax code should make America stronger at home and more competitive globally by increasing the incentive to work and invest in the United States. This includes fundamental corporate tax reform. That is why, in addition to these principles, the President is proposing a roadmap for corporate tax reform that will make America more competitive and create jobs here at home.

- *Observe the Buffett Rule.* No household making over $1 million annually should pay a smaller share of its income in taxes than middle-class families pay. As Warren Buffett has pointed out, his effective tax rate is lower than his secretary's. And, the President is now specifically proposing that in observance of the Buffett rule, those making over $1 million should pay no less than 30 percent of their income in taxes. The Administration will work to ensure that this rule is implemented in a way that is equitable, including not disadvantaging individuals who make large charitable contributions. And he is proposing that the Buffett rule should replace the Alternative Minimum Tax, which now burdens middle-class Americans rather than stopping the richest Americans from paying too little as was originally intended."

  and…

- "**Allow the 2001 and 2003 High-Income Tax Cuts to Expire and Return the Estate Tax to 2009 Parameters.** The tax cuts for those with household income above $250,000 per year passed in the Bush Administration were unfair and unaffordable at the time they were enacted and remain so today. In December 2010, congressional Republicans insisted on extending them through 2012 and threatened to allow taxes to increase on middle-class families if the Administration did not agree. Not extending the middle-class tax cuts would have hurt our nascent economic recovery, and would have imposed an enormous burden on working families; as a result, the Administration agreed to extend them to 2012 as
  part of a deal that also included immediate support for the economy in the form of a payroll tax cut and an extension of unemployment insurance. The Administration remains opposed to the

extension of these high-income tax cuts past 2012 and supports the return of the estate tax exemption and rates to 2009 levels. This would reduce the deficit by $968 billion over 10 years.

- "**Reduce the Value of Itemized Deductions and Other Tax Preferences to 28 Percent for Families With Incomes Over $250,000.** Currently, a millionaire who contributes to charity or deducts a dollar of mortgage interest, enjoys a deduction that is more than twice as generous as that for a middle-class family. The proposal would limit the tax rate at which high-income taxpayers can reduce their tax liability to a maximum of 28 percent, affecting only married taxpayers filing a joint return with income over $250,000 (at 2009 levels) and single taxpayers with income over $200,000. This limit would apply to: all itemized deductions; foreign excluded income; tax-exempt interest; employer sponsored health insurance; retirement contributions; and selected above-the-line deductions. The proposed limitation would return the deduction rate to the level it was at the end of the Reagan Administration. It would reduce the deficit by $584 billion over 10 years.

- **Tax Carried (Profits) Interests as Ordinary Income.** Currently, many hedge fund managers, private equity partners, and other managers in partnerships are able to pay a 15 percent capital gains rate on their labor income (on income that is known as "carried interest"). This tax loophole is inappropriate and allows these financial managers to pay a lower tax rate on their income than other workers. The President proposes
to eliminate the loophole for managers in investment services partnerships and to tax carried interest at ordinary income rates. This would reduce the deficit by $13 billion over 10 years.

- **Eliminate Special Depreciation Rules for Corporate Purchases of Aircraft.** Under current law, airplanes used in commercial and contract carrying of passengers and freight can be depreciated over seven years. Airplanes not used in commercial or contract carrying of passengers or freight, for example corporate jets, are depreciated over five years. The proposal would change depreciation schedules for corporate planes that carry passengers to seven years to be consistent with the treatment of commercial aircraft. This would reduce the deficit by $2 billion over 10 years.

- **Eliminate Oil and Gas Tax Preferences.** The tax code currently subsidizes oil and gas production through loopholes and tax expenditures that preference these industries over others. Current law provides a number of credits and deductions that are targeted toward certain oil and gas activities. In accordance with the President's agreement at the G-20 Summit in Pittsburgh in December 2009 to phase out subsidies for fossil
fuels so that we can transition to a 21st Century energy economy, the President is proposing to repeal a number of tax preferences available for fossil fuels. Getting rid of these would reduce the deficit by $41 billion over 10 years.

The following represents the key elements related to taxes in the President's budget request, per CBO's analysis. CBO's analysis, unlike the President's above, is measured against current law baseline:

- **Extending and Modifying the 2001 and 2003 Tax Reductions.** The President called for permanently extending, at 2012 levels, the tax rates on income, capital gains and dividends for couples with income below $250,000 who file jointly and for single filers with income below $200,000. For those with income above these thresholds, the President proposed to maintain the income tax rates, the phaseout of the personal exemption and the limit on itemized deductions that are scheduled to take effect in January 2013 under current law and to tax capital gains at a rate of 20 percent. In addition, the President proposed to continue the $1,000 child tax credit (which was raised by $500 in the 2001 tax cut law) and the reduced earnings threshold at which families can qualify for at least some of that credit (which was enacted under the 2009 economic stimulus package). *Reduce revenues: $2.1 trillion (over next 10 years); Increase spending: $314 billion (this would affect outlays because the tax credits involved are refundable)*

- **Alternative Minimum Tax (AMT).** Extend the current law exemption to the AMT, and index it to inflation. *Reduce revenues: $855 billion*

- **Limiting Deductions and Exclusions.** President proposed to limit the extent to which higher-income taxpayers can reduce their tax liability through certain deductions and exclusions to 28 percent of those deductions and exclusions. The limit would apply to itemized deductions as well as to deductions or exclusions for tax-exempt interest, employer-sponsored health insurance and employees' retirement contributions, among other things. *Increase revenues: $523 billion*

- **Modifying Estate and Gift Taxes.** Impose the 2009 level of the estate and gift tax starting in 2013 – estate tax exemption amount would be set permanently at $3.5 million (and at $7 million per couple) - any amount above the exemption level would be taxed at a rate of 45 percent; gift tax exemption amount would be set at $1 million with a top tax rate of 45 percent. *Lower revenues: $245 billion*

- **Targeting specific sources of tax avoidance associated with intangible assets (like patents and trademarks) and modifying tax rules for calculating foreign tax credits and expenses related to foreign operations.** *Raise revenues: $168 billion*

- **Permanently extend and modify the research and experimentation tax credit that expired at the end of 2011 making it retroactive to Jan. 1, 2012.** *Reduce revenues: $96 billion*

- **Make the American Opportunity Tax Credit (created by the 2009 economic stimulus package) permanent and index it for inflation (provides an annual tax credit of up to $2,500 per student for qualifying postsecondary education expenses).** *Decrease revenues: $81 billion; Increase spending: $27 billion (thus, adding $108 billion to the deficit)*

- **Extend 100 percent bonus depreciation through 2012.** *Decrease revenues: $32 billion in 2012; boost them by $27 billion over 2013-2022*

- **Impose a "financial crisis responsibility fee."** *Increase revenues: $61billion*

The President's "Framework for Business Tax Reform"

On Feb. 22, 2012, the White House and the Treasury Department issued a joint report outlining the "President's Framework for Business Tax Reform" (Framework).

This report features five elements:

1) "Eliminate dozens of tax loopholes and subsidies, broaden the base and cut the corporate rate [generally to 28 percent] to spur growth in America;"
2) "Strengthen American manufacturing and innovation;"
3) "Strengthen the international tax system, including establishing a new minimum tax on foreign earnings, to encourage domestic investment;"
4) "Simplify and cut taxes for America's small businesses;"
5) "Restore fiscal responsibility and not add a dime to the deficit."

In general, this proposal would lower the corporate income tax rate and broaden the tax base through various tax policy changes. Both of these basic changes have been not only repeatedly suggested by Republicans, but also by the Obama Administration.

Editor's Note: *Since this document was relatively light on details and more or less presents an overall vision of business tax reform, this summary will primarily be relayed by directly quoting portions of the report so that nothing is assumed or asserted based off its rather vague proposals.*

"Eliminate dozens of tax loopholes and subsidies, broaden the base and cut the corporate rate [generally to 28 percent] to spur growth in America"

The Framework would reduce the top corporate tax rate from its current 35 percent to 28 percent. To pay for this lower corporate tax rate (borrowing heavily from the President's fiscal year FY 2013 budget request), the Framework provides examples of "specific reductions in tax expenditures and loophole closers that should be part of any reform" including:

- "eliminate the last in, first out (LIFO) method of accounting for inventories" (this rule currently allows some companies to reduce their tax liability below what it would be under international accounting norms)
- "eliminate oil and gas tax preferences"
- "reform [the] treatment of insurance industry and products"
- "tax carried (profits) interest as ordinary income"
- "eliminate special depreciation rules for corporate purchases of aircraft"

The Framework also proposes to "reform the corporate tax base" by laying out "a menu of options that should be under consideration" – specifically:

- "addressing depreciation schedules" by scaling back the system of accelerated depreciation so companies deduct value of their property and equipment over a longer period of time than currently allowed
- "reducing the bias toward financing" through, for example, "reducing the deductibility of interest for corporations"
- "establishing greater parity between large corporations and large non-corporate counterparts" presumably by imposing corporate taxes on non-corporate businesses (e.g. partnerships, S corporations and sole proprietorships)
    - the proposal does not give specifics as to a definition of who would fall under the "large non-corporate businesses" category, but it does reference the 2005 Presidential Tax Reform panel report which defines a "large business" as one with $10 million or more in receipts – this particular option could pose troubling to small

and medium-sized businesses due to possible implications of "establishing greater parity" and what that may actually mean

Finally, the Framework states that it would "improve transparency and reduce accounting gimmicks" involving, for example, "the gap between book income, reported to shareholders, and taxable income, reported to the IRS."

"Strengthen American manufacturing and innovation"

The Framework contains three specific incentives designed to "strengthen America's manufacturing sector and encourage greater innovation":

- "refocus the manufacturing deduction and use the savings to reduce the effective rate on manufacturing to no more than 25 percent, while encouraging greater research and development and the production of clean energy" – specifically, "focus the deduction more on manufacturing activity, expand the deduction to 10.7 percent, and increase it even more for advanced manufacturing"
- "expand, simplify and make permanent the Research and Experimentation Tax Credit" at a rate of 17 percent
- "extend, consolidate and enhance key tax incentives to encourage investment in clean energy" making the Section 45 production tax credit permanent as well as refundable

"Strengthen the international tax system, including establishing a new minimum tax on foreign earnings, to encourage domestic investment"

The Framework states that "our tax system should not give companies an incentive to locate production overseas or engage in accounting games to shift profits abroad, eroding the U.S. tax base. Introducing a minimum tax on foreign earnings would help address these problems and discourage a global race to the bottom in tax rates." Under current law, U.S. firms operating through a foreign subsidiary do not pay U.S. tax on foreign income as long as those earnings remain overseas.

This international portion of the Framework includes three components:

- would "require companies to pay a minimum tax on overseas profits" by subjecting foreign income earned in a "low-tax jurisdiction" to "immediate U.S. taxation up to the minimum tax rate with a foreign tax credit allowed for income taxes on that income paid to the host country" – the report does not make it clear how profits U.S. companies have kept abroad for years would be treated under this new minimum tax rule
    - Example: If the U.S. minimum tax rate is set at 20 percent and a company pays eight percent to the host country, it will have to pay the 12 percent difference to the U.S.
- would "remove tax deductions for moving productions overseas and provide new incentives for bringing production back to the United States" – U.S multinationals that move operations back to the U.S. would get a 20 percent tax credit
- would make "other reforms to reduce incentives to shift income and assets overseas" such as by "taxing currently the excess profits associated with shifting intangibles to low tax jurisdictions" and by "requiring that the deduction for the interest expense attributable to overseas investment be delayed until the related income is taxed in the United States"

This proposal regarding the international tax system is in great contrast to Ways and Means Committee Chairman Dave Camp's Discussion Draft released last year which proposed to adopt a dividend exemption "territorial" international tax system. The President's Framework would retain the current worldwide international tax system and, in fact, extend its reach through restrictions on deferral and an unspecified minimum tax on foreign earnings of U.S. companies. The President's Framework and Chairman Camp's proposal reflect competing views of how capital is deployed in the global economy and the motivations of U.S. companies in locating business activities within the United States and elsewhere.

"Simplify and cut taxes for America's small businesses"

According to the Framework, "tax reform should make tax filing simpler for small businesses and entrepreneurs so that they can focus on growing their businesses rather than filling out tax returns" and it includes provisions "so that small businesses, including small pass-throughs, receive a net tax cut from reform." The Framework includes four specific proposals in this area:

- would "allow small businesses to expense up to $1 million in investments" on a permanent basis
- would "allow cash accounting on businesses with up to $10 million in gross receipts," up from the $5 million threshold today
- would "double the deduction for start-up costs" from $5,000 to $10,000
- would "reform and expand the health insurance tax credit for small businesses," allowing businesses with up to 50 workers, rather than 25 today, to qualify, among other modifications

H. Con. Res. 112, FY 2013 House Budget Resolution

On March 20, 2012, House Budget Committee Chairman Paul Ryan released the Budget Committee's FY 2013 Budget Resolution, The Path to Prosperity: A Blueprint for American Renewal, and formally introduced to the House on March 23, 2012. Click here to view the full bill text.

On March 29, 2012, H. Con. Res. 112 passed the House by a vote of 228-191. Click here to see how they voted.

Along with numerous other provisions and proposals, this budget resolution made the following key points regarding what it refers to as, "Pro-Growth Tax Reform:"

- "The tax code has become a broken maze of complexity and political favoritism, overgrown with special-interest loopholes and high marginal rates that stifle economic growth and job creation.

- "This budget reforms the broken tax code to spur job creation and economic opportunity by lowering rates, closing loopholes, and putting hardworking taxpayers ahead of special interests. The pro-growth reforms ensure the tax code is fair, simple, and competitive.

- "This budget consolidates the current six individual income tax brackets into just two low brackets of 10% and 25% and repeals the Alternative Minimum Tax.

- "This budget reduces the corporate rate to 25% and shifts from a 'worldwide' system of taxation to a 'territorial' tax system that puts American companies and their workers on a level playing field with foreign competitors.

- "This budget rejects the President's call to raise taxes. Instead, it broadens the tax base to maintain revenue growth at a level consistent with current tax policy and at a share of the economy consistent with historical norms of 18% to 19% in the following decades."

To gain access to the multitude of documents provided by the House Budget Committee on the FY 2013 Budget Resolution, please click here.

Editor's Note: *For more information regarding the FY 2012 House Budget Resolution, please refer to the Budget and Federal Spending chapter of the 2012 NRCC Issues Book.*

TAX POLICY TALKING POINTS

- I share the frustration of every American taxpayer who has seen their hard-earned dollars wasted on Washington's failed spending sprees.
- We need to simplify our tax code by lowering rates, eliminating special interest loopholes and the crony-capitalism that is part of the system.
- Tax reform done right will help grow the economy and increase revenues without raising tax rates.
- The real issue with our debt is a spending problem, not a taxing problem. It is time Washington started having a discussion about spending less rather than taxing more.
- We have to stop spending money we do not have. In order to get Washington spending under control we have to restore fiscal responsibility.
- The only people who have voted to raise taxes on middle-class families are the people who voted for the Democrats' government takeover of health care. I am fighting to reduce taxes on middle-class families, while my opponent who supports ObamaCare and the wasteful stimulus will increase the tax burden on middle-class families.

ADDITIONAL INFORMATION AND RESOURCES

- Americans for Tax Reform (ATR) – http://www.atr.org/
- House Ways and Means Committee – http://waysandmeans.house.gov/
- Internal Revenue Service (IRS) – http://www.irs.gov/
- The Joint Committee on Taxation (JCT) – http://www.jct.gov/
- National Taxpayers Union (NTU) – http://www.ntu.org/
- Office of Tax Policy, U.S. Department of Treasury – http://www.treasury.gov/resource-center/tax-policy/
- The Tax Foundation – http://www.taxfoundation.org/
  Editor's Note: *The Tax Foundation is a nonpartisan, educational organization that conducts and publishes research on tax policy. Obviously, they do have their own perspective on certain tax issues, but in general, their work product is at least a good point of reference.*
- Tax Statistics, IRS – http://www.irs.gov/taxstats/
- U.S. Department of Treasury – http://www.treasury.gov/